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PARTICIPATION MORTGAGES AS A METHOD OF TRUST INVESTMENT BY CORPORATE FIDUCIARIES[1]

To find suitable investments for funds of trust estates has been one of the most difficult problems of fiduciary administration in recent years. An important factor contributing to this problem is the fact that the development of new fields for trust investment has not kept pace with the enormous increase in the use of the trust device, an increase marked especially by the establishment of a large number of small trust funds.[2] One type of investment which, prior to

1. This Comment is in a large measure founded upon information received from various banks and trust companies throughout the United States. The cooperation of those institutions is greatly appreciated, especially since data otherwise unavailable was thus secured.

2. A "small trust" is usually regarded as one of less than $25,000. As of June 30, 1931, the individual trusts handled by national banks averaged $49,319, but trusts of less than $25,000 occurred most frequently. RIDDLE, THE INVESTMENT POLICY OF TRUST INSTITUTIONS (1934) c. 3; Clifford, *Commingled Trust Funds* (1933) 11 HARV. BUS. REV. 253; cf. Barclay, *Commingled Funds Offer Broader Scope for Trust Service* (1931) 53 TRUST CO. 615.

1931 at least, combined a comparatively high rate of return with a minimum of risk, was a note or bond secured by a first mortgage or trust deed of real estate.[3] Such mortgages have long been favored by trustees, and today they are included on the list of "legals" in almost all the states which restrict by statute the power of trustees to make investments.[4] However, the utility of real estate mortgages as a medium of trust investment was greatly diminished in large urban communities by the scarcity of good mortgages small enough for the investment of the funds of a single trust. To make possible the investment of funds of small trusts in large mortgages and to secure a distribution of risk for all trusts, in the last decade of the nineteenth century corporate trustees evolved the participation mortgage,[5] by means of which several trusts

3. Unless the context makes a different meaning necessary, wherever hereafter the term "mortgages" is used, it will include not only the mortgages themselves, but also the accompanying notes or bonds and all other documents generally transferred to mortgagees in connection with loans upon real estate security.

4. In Matter of Balfe, 152 Misc. 739, 748, 274 N. Y. Supp. 284, 295 (Surr. Ct. 1934), Surrogate Taylor speaks of the real estate mortgage as "the security eternal." Cf. Bishop v. People's Bank & Trust Co., 218 Ky. 508, 291 S. W. 718 (1927); King v. Talbot, 40 N. Y. 76 (1869); Curran's Estate, 312 Pa. 416, 167 Atl. 597 (1933). The statutes are: CONN. GEN. STAT. (1930) § 4836; COLO. ANN. STAT. (Mills, 1930) § 7946; Del. Laws 1931, c. 259, § 1; FLA. COMP. GEN. LAWS ANN. (Supp. 1934) § 6127 (1); IDAHO CODE ANN. (1932) § 25-1502(e); Ind. Laws 1933, c. 40, § 186 (c); ILL. REV. STAT. (Cahill, 1935) c. 3, § 144; IOWA CODE (1935) § 12772; KAN. REV. STAT. ANN. (1923) § 40-307; KY. STAT. (Carroll, 1930) § 4706; LA. GEN. STAT. (Dart, 1932) § 589; MINN. GEN. STAT. (1927) § 7714; N. Y. BANK. LAW (1935) § 188 (7); N. Y. DEC. EST. LAW (1935) § 111; N. Y. PERS. PROP. LAW (1935) § 21; MONT. REV. CODE ANN. (Choate, 1921) § 10306; N. J. COMP. STAT. (Supp. 1930) tit. 72, § 37a; N. M. STAT. ANN. (Courtright, 1929) § 13-135; OHIO GEN. CODE (Page, Supp. 1935) § 10506-41; ORE. CODE ANN. (1930) § 22-1214, as amended by Ore. Laws 1931, c. 278, § 17; PA. STAT. ANN. (Purdon, 1935) tit. 20, § 801 (4); R. I. GEN. LAWS (1923) tit. 372, § 32; S. C. CODE (1932) § 9051; S. D. COMP. LAWS (1929) § 9049; TENN. CODE ANN. (Williams, 1934) § 9596.1(f); TEX. REV. CIV. CODE (Vernon, 1935) art. 511; VT. PUB. LAWS (1933) § 6706; VA. CODE (Michie, Supp. 1934) § 5431; WASH. COMP. STAT. (Remington, 1932) § 3255; W. VA. CODE (Michie, 1931) c. 44, art. 6, § 2; WIS. STAT. (1933) § 231.32; WYO. REV. STAT. (1931) § 10-305.

5. The participation mortgage was used in Massachusetts in 1892. Record, 13, Springfield Safe Deposit & Trust Co. v. First Unitarian Society, Case No. 478, Sup. Jud. Ct. Mass., Sept. Sitting, 1935. Cf. Matter of Flint, 240 App. Div. 217, 269 N. Y. Supp. 470 (2d Dep't, 1934), aff'd mem., 266 N. Y. 607, 195 N. E. 221 (1935); Berger, *Pooling or Participation Mortgages as Investments for Trust Funds* (1929) 48 TRUST CO. 599; McKinney, *The Legality of Participating Mortgage Certificates as Investments for Trustees* (1915) 24 YALE L. J. 286. In a sense participation mortgages are but one instance of the application of the common investment fund idea to the particular field of mortgages. On this common fund investment idea, see RIDDLE, *loc. cit. supra* note 2; BOGERT, TRUSTS AND TRUSTEES (1935) § 677; Clifford, *supra* note 2; Whittlesey, *Commingled Fund Recommended as Solution of Several Major Trust Problems* (1934) 58 TRUST CO. 321; Fenninger, *Common Trust Fund Problems* (1935) 60 TRUST CO. 144. The idea of the participation mortgage has also been applied to the holding of fee simple title to land in trust by a trust company, and the issuance against such title of land trust certificates. This seems to have been done most extensively in Ohio. Cf. In re Hotel Gibson Co., 11 F. Supp. 30 (S. D. Ohio, 1935), noted in (1935) 49 HARV. L. REV. 143; Goldman and Abbott, *Land Trust Certificates* (1928) 2 U. OF CIN. L. REV. 255.

were enabled to invest in a single mortgage or group of mortgages. In the period from 1920 to 1930 the participation mortgage reached its highest development, being used widely throughout the United States in many different forms. But because of the acute deflation in real estate values in many localities since 1931, mortgages themselves are not currently regarded as desirable investments, and consequently the use of participation mortgages has greatly declined.[6]

Two kinds of institutions, trust companies and title insurance and mortgage companies, are principally responsible for the development of the participation mortgage device. The trust companies have used it mainly as a means of investing the funds of which they are trustees, although in some states they have sold participating interests in such mortgages to the public as well.[7] Title insurance and mortgage companies seized upon the device as one which opened up a new and fertile field for private investment, particularly when coupled with a guaranty of the principal and interest of the participating shares.[8] In this Comment, attention is directed principally to the situation in which a trust company has used the participation mortgage as a device for investing the funds of trusts of which it is trustee.

The Creation and Operation of Participation Mortgage Plans

The details of participation mortgage plans vary greatly in different sections of the United States, but are of two general factual types. The first involves the creation of participating interests in a single mortgage, hereafter referred

6. Bailey and Rice, *The Duties of a Trustee with Respect to Defaulted Mortgage Investments* (1935) 84 U. OF PA. L. REV. 157; Gouley, *Real Estate Mortgage Bonds as Trust Investments* (1935) 83 U. OF PA. L. REV. 953.

7. Illustrative cases are Reichert v. Metropolitan Trust Co., 262 Mich. 123, 247 N. W. 128 (1933); Croghan v. Savings Trust Co., 85 S. W. (2d) 239 (Mo. App. 1935); Kelly v. Middlesex Title Guarantee & Trust Co., 116 N. J. Eq. 228, 172 Atl. 487 (Ch. 1934); Seaboard Trust Co. v. Shea, 118 N. J. Eq. 433, 180 Atl. 206 (Ch. 1935); Ulmer v. Fulton, 129 Ohio St. 323, 195 N. E. 557 (1935); Werner v. Gordon, 38 Dauphin County 8 (Pa. C. P. 1933).

8. The most striking difference between participating mortgage certificates issued by trust companies and those issued by title insurance and mortgage companies is that only rarely does a trust company guarantee the payment of the principal and interest of its certificates, even when issued to the general public. This guaranty is a normal part of the certificates issued by title insurance and mortgage companies, and in New York City and elsewhere it has resulted in nearly all such companies' being unable to meet their obligations during the depression. The cases and other literature on the guaranteed mortgage certificates are innumerable, especially since the rehabilitation of the mortgage guaranty companies has been undertaken in New York under the Schackno Act and the Mortgage Commission Act. It is not the purpose of this Comment to consider those problems, but the following cases and articles indicate some of the complicated problems which have arisen. People v. Title & Mortgage Guaranty Co. of Buffalo, 264 N. Y. 69, 190 N. E. 153 (1934); Matter of Balfe, 152 Misc. 739, 274 N. Y. Supp. 284 (Surr. Ct. 1934); Matter of Bond & Mortgage Guarantee Co., 157 Misc. 240, 283 N. Y. Supp. 623 (Sup. Ct. 1935); Proffitt, *Trustee's Problems in Handling Guaranteed Mortgages* (1933) 57 TRUST CO. 479; Naumburg, *Status of Guaranteed Mortgages as Fiduciary Investments* (1933) 57 TRUST CO. 59; Comment (1934) 34 COL. L. REV. 663.

to as a straight participation mortgage; the second, the creation of participating interests in a pool of mortgages. Both types have been used by trust companies, although the most extensive use of the mortgage pool has been by title insurance and mortgage companies.[9] Up to the present time the straight participation mortgage has been used in one form or another by trust companies in at least twenty states, while their use of the mortgage pool has been confined to a relatively few states.[10]

There are two normal methods of setting up a straight participation mortgage.[11] One method is for a trust company to combine the funds of several trusts of which it is trustee, and with these combined funds to acquire a first mortgage on real estate. This mortgage in some instances is held by the trust company in its corporate capacity, but to insure the legality of the device it is better to indicate the fiduciary capacity in some manner unless express authorization is given by statute or by the trust instrument to hold such mortgages in the corporate capacity.[12] The second and more frequent method used to create a straight participation mortgage is for the trust company through its banking department to acquire a mortgage with its own funds, and then at some subsequent date to declare itself trustee of the mortgage for various trust estates, whose funds will then be used to reimburse the banking department for the original expenditure.[13]

Once a mortgage is acquired by the trust department, it is always separated in the trust department's files from the other assets of the trust company. Where the number of trusts which have a participating interest in the mortgage is small, the names of those trusts may be contained in a memorandum attached to the mortgage itself or to the declaration by the trust company that it holds the mortgage in trust. Complete records of the mortgage and of the interest

9. This is especially true of New York City, where enormous amounts were invested in mortgage pools operated by mortgage guaranty companies. In Pennsylvania some trust companies also have the powers of title insurance companies. E.g., United States Bank & Trust Co. Case, 311 Pa. 320, 166 Atl. 871 (1933); Kisinger v. Pennsylvania Trust Co., 180 Atl. 79 (Pa. Super. 1935). In other states other types of corporations have issued participating mortgage certificates. Colorado Investment & Realty Co. v. Newkirk, 95 Colo. 71, 32 P. (2d) 830 (1934); Mayor and City Council of Baltimore City v. Harper, 148 Md. 234, 129 Atl. 641 (1925).

10. See *infra*, pp. 876-877.

11. For general description of the manner of setting up and operating a straight participation mortgage, the following cases and references contain fairly adequate accounts. Bowden v. Citizens' Loan & Trust Co., 259 N. W. 815 (Minn. 1935); Matter of Flint, 240 App. Div. 217, 269 N. Y. Supp. 470 (2d Dep't, 1934); Matter of Peene, 155 Misc. 155, 279 N. Y. Supp. 131 (Surr. Ct. 1935); Record, Springfield Safe Deposit & Trust Co. v. First Unitarian Society, Case No. 478, Sup. Jud. Ct. of Mass., Sept. Sitting, 1935; BRADY, BANK MANAGEMENT OF DECEDENTS' ESTATES (1932) §§ 107, 108; Miller, *Allocation of Small Trust Balances to Mortgages and Bonds* (1930) 50 TRUST CO. 581; Peters, *Some Problems Affecting Various Types of Commingled Trust Funds* (1931) 53 TRUST CO. 325.

12. As to the legality of holding title to the mortgages in either the corporate or trust capacity, see *infra*, p. 870. As to disadvantages of holding in trust capacity, see Brief of Amicus Curiae Russell Chapin, 10, Springfield Safe Deposit & Trust Co. v. First Unitarian Society, Case No. 478, Sup. Jud. Ct. of Mass., Sept. Sitting, 1935.

13. See note 54, *infra*.

therein of each trust estate are kept at all times so that they can be readily ascertained. It is the usual practice to issue a participating certificate to each trust which holds a partial interest in a mortgage, these certificates being placed in the portfolios of the respective trusts. Originally such certificates were extremely simple, merely stating that the trust estate was the owner of a participation of a certain amount in a certain mortgage held by the trust company for the equal benefit of all the certificate holders, and that the trust estate was entitled to participate pro rata in the principal and interest collected on the mortgage, less a pro rata deduction by the trust company to cover the reasonable costs of administration of the mortgage. In other instances the certificate stipulated that a flat rate of interest such as five per cent should be paid, and the difference between that rate and that paid by the mortgagor went to the trust company to cover its expenses; in still others no charge whatever has been made by the trust company for its services in administering the mortgage.[14] More recently the tendency has been to add further provisions to the certificates so as to constitute each certificate in effect a separate declaration of trust by which the trust company is made trustee of the mortgage and given complete powers with respect to its administration, such as the power to make extensions of the maturity of the principal and interest of the mortgage, to change the rate of interest on the mortgage, to foreclose the mortgage, and to do all other similar acts which an owner of a mortgage can do.[15] The necessity for such provisions became apparent in some states, where on the termination of a trust the participating certificates were distributed to the former beneficiaries. In such instances there was often no clear authority for the trust company to continue to administer the mortgage for the benefit of this type of certificate holder. Under the more detailed certificates, however, the trust company would continue to be trustee of the mortgage for the benefit of all the certificate holders until the mortgage debt was paid.[16] Prior to 1931, when a trust terminated before the maturity of the mortgage, the trust company generally preferred to distribute cash rather than the certificates to the beneficiaries, even though distribution in cash was not required, and often purchased the interest of the terminated trust for some other trust of which it was trustee. If no other trust had funds available for investment at the moment, the trust company would purchase the participating interest in its corporate capacity through its banking department and hold it for future investment purposes. Conditions since 1931 have made this practice less frequent because of the inadvisability of loading up the banking depart-

14. Cf. Bowden v. Citizens' Loan & Trust Co., 259 N. W. 815 (Minn. 1935); Rems Estate, 15 Lehigh County 348 (Pa. O. Ct. 1932).

15. Examples of participation certificates are to be found in Matter of Union Trust Co., 219 N. Y. 514, 114 N. E. 1057 (1916); Matter of Thomson, 135 Misc. 62, 237 N. Y. Supp. 622 (Surr. Ct. 1929); Ulmer v. Fulton, 129 Ohio St. 323, 195 N. E. 557 (1935); Squire v. Central United Nat. Bank, Daily Legal News and Cleveland Recorder, Cleveland, Ohio, Dec. 19, 1935, at 1; Matter of Commercial Trust Co., 36 Dauphin County 393 (Pa. C. P. 1933); In re Manayunk Trust Co. (No. 2), 21 D. & C. 405 (Pa. C. P. 1934).

16. In New York and Pennsylvania the power to do all such acts is given by statute. N. Y. BANK. LAW (1935) § 188(7); PA. STAT. ANN. (Purdon, 1935) tit. 7, § 809-1109. Cf. Blair v. Pennsylvania Co., 24 D. & C. 490 (Pa. C. P. 1935).

ment with a large volume of participations. Consequently there have been more frequent distributions of the participating certificates themselves.

In many states trust companies have used a device less highly developed than the straight participation mortgage, but similar to it in many respects. Known as the split mortgage, it is set up in much the same way as the straight participation mortgage, save that the mortgagor, instead of executing a single note or bond secured by the mortgage of real estate, will execute several notes or bonds of small denominations, possibly varying in amount and date of maturity, but all secured by a single mortgage. Then, instead of issuing participating certificates to the various trusts which have contributed funds, the trust company will place notes and bonds in the portfolios of each trust in proportion to the amount each contributed.[17] Compared with a straight participation mortgage, the split mortgage involves more administrative difficulties in that it requires the acquiescence and cooperation of the mortgagor, and it is less flexible in operation because of the fixed denominations of the notes or bonds. However, apparently because each trust holds a direct obligation of the mortgagor rather than a mere certificate of interest in a mortgage of which the trust company has complete control, this type of participation mortgage seems to be regarded as less subject to attack on the ground of illegality than a straight participation mortgage. Yet, in reality there would seem to be little difference between the two so long as the device is operated entirely within a trust company, for in both cases the control of the trust company as mortgagee and as trustee of the individual trusts is the same.[18]

Between 1920 and 1930 the desire to utilize the possibilities of the participation mortgage device to its fullest extent led to the creation of the mortgage pool. While the method of setting up a mortgage pool follows the general outlines of that used to create a straight participation mortgage, some of the details are quite different.[19] The initial step is for the trust company to acquire first mortgages on real estate, usually in its corporate capacity.[20] When a sufficient number of mortgages has been acquired and sufficient funds of trusts are available for investment, the trust company executes a declaration of trust constituting itself trustee for the mortgage pool, and such mortgages will

17. Cf. In re Guardianship of Lutz, 280 Ill. App. 587 (1935); In the Matter of the Estate of Lalla, App. Ct., 1st Dist., Ill., July 5, 1935.

18. See note 82 *infra,* for cases involving the legality of this type of investment.

19. Excellent descriptions of the creation and operation of mortgage pools are contained in Squire v. Central United Nat. Bank, Daily Legal News and Cleveland Recorder, Cleveland, Ohio, Dec. 19, 1935, at 1; Estate of Mary L. Iredell, 51 Montgomery County 174 (Pa. O. Ct. 1934). Cf. also Commonwealth Trust Co. v. Atwood, 78 F. (2d) 92 (C. C. A. 3rd, 1935); Gratzinger v. Arehart, 198 N. E. 787 (Ind. 1935); Matter of Union Trust Co., 219 N. Y. 514, 114 N. E. 1057 (1916); Roberts's Trust Estate, 316 Pa. 545, 175 Atl. 869 (1934); Merion Title & Trust Co.-Huff Memorial Scholarship Fund, 23 Delaware County 557 (Pa. C. P. 1933); Berger, *supra* note 5. In Pennsylvania, prior to 1931, installment mortgage pools were operated with apparently a high degree of success. In such pools the mortgagor made payments monthly, covering both principal and interest, for a period varying from three to five years, which payments were passed on to the certificate holders. Cf. Crick's Estate, 315 Pa. 581, 173 Atl. 327 (1934).

20. See note 54, *infra.*

be segregated from the other assets of the trust company. As funds of various trusts are invested in the pool, participating certificates are issued, ordinarily only one certificate being issued to each trust. In some instances the issuance of certificates has been regarded as cumbersome and unnecessary, and instead an "asset card" is kept for each trust, on which every transaction which takes place in reference to that trust is recorded.[21] The interest may be paid in a pro rata share or at a flat rate, and it is always provided that the trust company shall have the exclusive power to administer the mortgages in the pool. In the operation of most mortgage pools a usual feature is the existence of an equity in the pool held by the trust company in its corporate capacity, often referred to as the "float." When a trust is to be distributed in cash, the banking department of the trust company pays to the trust department the amount of the certificate, which is then distributed, and the banking department acquires the interest in the pool formerly held by the trust, thus increasing the equity in the pool of the trust company in its corporate capacity. When a new trust is to come into the pool, the process is reversed and the trust company's equity is correspondingly decreased. The banking department usually receives a return from the pool in proportion to the amount of the trust company's equity therein, just as an ordinary certificate holder, and in the event of liquidation of the trust company, it has been held that the liquidator representing the banking department is entitled to come in on an equal basis with the other certificate holders in the distribution of the assets of the pool.[22] Since the existence of this "float" exposes the trust company to the charge of self-dealing, some trust companies feel it should be eliminated as a banking department transaction, and instead that it should be cared for by requiring the pool to carry its own cash.[23] Thus a certain percentage of the pool assets would always be in cash and available for liquidating purposes. While this would probably result in decreasing the yield from the pool, it would do much towards eliminating one of the principal legal objections to the mortgage pool device.[24]

The so-called power of substitution may or may not be present in the operation of a mortgage pool. This power permits the trust company operating the pool to withdraw mortgages from the pool at any time and to replace them with other mortgages of equal value. By this means mortgages which are in default may be removed from the pool and be replaced by good mortgages, thus making it possible to maintain the security of the pool unimpaired. On the

21. Estate of Mary L. Iredell, 51 Montgomery County 174 (Pa. O. Ct. 1934).

22. Commonwealth Trust Co. v. Atwood, 78 F. (2d) 92 (C. C. A. 3d, 1935); Kelly v. Middlesex Title Guarantee and Trust Co., 115 N. J. Eq. 592, 171 Atl. 823 (Ch. 1934); cf. Matter of Lawyers Mortgage Co., 151 Misc. 744, 272 N. Y. Supp. 390 (Sup. Ct. 1934). But cf. Matter of Lawyers Westchester Mortgage & Title Co., N. Y. L. J., Feb. 28, 1936, at 1056, col. 2; Morton, *Liquidating One of the Largest Mortgage Pools in Captivity* (1932) 55 TRUST Co. 695, where apparently the trust company's equity did not inure to the benefit of the banking department till all the other pool participants had been paid off in full.

23. A certain percentage of the funds of each trust would be retained by the trust department, at the time the pool is set up, to provide cash.

24. See p. 873, *infra*.

other hand, in a few instances trust companies have exercised this power to the detriment of the trusts which held participating certificates.[25] Since such a power of substitution may be held to constitute self-dealing, the more general and better practice is to operate pools without the power of substitution.[26]

Where a trust company issues participating certificates in a mortgage pool to its trusts and also sells certificates in the same pool to the general public, it exposes itself to the temptation to over-appraise the value of the real estate securing the mortgages in order to sell more certificates, and as a result the trusts are prejudiced.[27] For institutions engaged solely in the banking and trust business, this practice of selling participating certificates to the public is not to be recommended, and the most recent comprehensive legislation on the subject has expressly forbidden it.[28]

The Practical Utility of the Participation Mortgage Device

As a medium of trust investment, properly administered straight participation mortgages, split mortgages and especially mortgage pools all afford practical advantages to both the beneficiaries of the trusts and to the trust company.[29] Their use is advantageous to the beneficiaries in that it makes possible the investment of funds of small trusts in mortgages, whereas separate investment of such funds might, because of the insufficient amount of small mortgages available, result in a lower yield. They have proved particularly convenient as a means of ready investment of small amounts of principal and income of trusts accruing from time to time, and which otherwise could not be invested profitably at so early a date. In some states the use of participation mortgages has resulted in a substantial increase in the average yield from all trust estates. Proper diversification within the real estate mortgage field is also made possible, since the funds of a single trust can be allocated to several different straight participation mortgages. This spreading of the risk is inherent in the nature of the mortgage pool device, which also has the additional special

25. Ulmer v. Fulton, 129 Ohio St. 323, 195 N. E. 557 (1935); Squire v. Central United Nat. Bank, Daily Legal News and Cleveland Recorder, Cleveland, Ohio, Dec. 19, 1935, at 1. In the latter case on one occasion $3,000,000 worth of choice mortgages were withdrawn to be used by the bank as collateral for the deposit of public funds.

26. See p. 873, *infra* for a discussion of the legal objections to this power.

27. For an example of this double use of the participation mortgage, see Werner v. Gordon, 38 Dauphin County 8 (Pa. C. P. 1933), where of a mortgage pool amounting to $363,740, $228,675 was sold to the public and $125,211 were used for the investment of funds of trusts of which the trust company was trustee. In Michigan, where a trust company issued guaranteed participating mortgage certificates solely to the public, the guarantee was held invalid as against public policy since it imperiled the trust funds committed to the company's care. Also cf. Reichert v. Metropolitan Trust Co., 262 Mich. 123, 247 N. W. 128 (1933); Report of Streit Committee, N. Y. Times, Feb. 24, 1936, at 25, col. 1.

28. PA. STAT. ANN. (Purdon, 1935) tit. 7, § 819-1109.

29. For general discussions of both advantages and disadvantages, consult Klein's Estate, 22 D. & C. 490 (Pa. O. Ct. 1934); Berger, *supra* note 5; Clifford, *supra* note 2; Knowles, *Pooling of Mortgages for Trust Investment* (1928) 46 TRUST CO. 631; Morton, *supra* note 22; Standeven, *Installation and Operation of "Mortgage Investment Trust Account"* (1929) 49 TRUST CO. 663; Whittlesey, *supra* note 5.

advantage of assuring continuity of investment, for as soon as one mortgage matures, it is replaced by another. It also provides a more equal treatment for all trusts of which a trust company is trustee; it is extremely flexible in operation; and because of the large volume of mortgages which are handled, a specialized mortgage loan department can be set up, thereby making possible more frequent and better appraisals and reappraisals of the mortgage security. For the trust company, one of the biggest advantages prior to 1931 was that a well conducted mortgage pool ordinarily resulted in a substantial increase in its volume of trust business. Furthermore, since all mortgage transactions could be concentrated in one department, it was thus possible to reduce operating costs.[30]

The practical disadvantages of the participation mortgage device have mostly appeared since 1931, when the economic depression began seriously to affect the real estate mortgage market. The severe deflation in real estate values in most communities made trustees extremely cautious in investing in mortgages. Furthermore, where the trust company was bound by the terms of a trust to pay over cash to the beneficiaries on the termination of a trust, the self-created market within the trust company which formerly existed practically disappeared, the trust company not desiring or being able to take over the participating certificates, either for another trust or for its banking department. For this reason many trust companies ceased, at least temporarily, to invest in participation mortgages.[31] Further complications have arisen from the numerous defaults by mortgagors on both principal and interest. With increasing frequency the trust company has been forced to foreclose mortgages and take over and administer the mortgaged properties, thus preventing cash distribution upon termination of trusts and also increasing the administrative burden of the trust company.[32] In some states the solution of this problem has been to distribute the participating certificates to the beneficiaries unless a cash distribution is made necessary by the terms of the trust.[33] As mentioned previously, the beneficiaries are always subject to the risk of mismanagement by the trust company, a risk which is substantially increased in a mortgage pool in which the trust company has the power of substitution.[34]

30. Squire v. Central United Nat. Bank, Daily Legal News and Cleveland Recorder, Cleveland, Ohio, Dec. 19, 1935, at 1; Clifford, *supra* note 2; Standeven, *supra* note 29. As compared to an equal amount of straight participation mortgages, a mortgage pool entails less bookkeeping and other clerical work.

31. This has been the experience of certain trust companies in Connecticut, Delaware, Indiana, Pennsylvania and Washington. Cf. Kefover v. Potter Title & Trust Co., 181 Atl. 771 (Pa. 1935).

32. On foreclosure, cf. Kelly v. Middlesex Title Guarantee & Trust Co., 115 N. J. Eq. 592, 171 Atl. 823 (Ch. 1934); Scheetz v. Tradesmen's Nat. Bank, 23 D. & C. 209 (Pa. C. P. 1935); Blair v. Pennsylvania Co., 24 D. & C. 490 (Pa. C. P. 1935).

33. For circumstances under which payment in cash may be necessary, cf. Osterling v. Commonwealth Trust Co., 181 Atl. 769 (Pa. 1935); Matter of Leeds, 154 Misc. 228, 276 N. Y. Supp. 950 (Surr. Ct. 1935). For circumstances under which certificates may be distributed, cf. Crick's Estate, 315 Pa. 581, 173 Atl. 327 (1934); Matter of De Winter, 154 Misc. 50, 276 N. Y. Supp. 576 (Surr. Ct. 1934).

34. Cf. cases cited in note 25, *supra*.

Further difficulties insofar as the trust company is concerned arise from inconveniences occasioned by lack of uniformity in the type of trusts[35] and by variations in directions of settlors and testators as to the scope of the investment powers of the trust company. This latter difficulty has led to the suggestion by trust companies that the power to invest in participation mortgages and other types of common funds be expressly inserted in the instrument creating the trust.[36]

The Legality of the Participation Mortgage Device

Prior to the present depression the participation mortgage device was generally operated so profitably that its legality was rarely questioned. Since 1931, however, challenges to this method of investment by both corporate and individual trustees have been constantly increasing. The question is most frequently raised where substantial diminutions in income lead beneficiaries of trusts to ask for accountings or where objections have been made to attempts to distribute participating certificates in lieu of cash on the termination of trusts.[37] Another situation in which the question frequently arises is in the liquidation of trust companies closed after the bank holiday in March, 1933. Here the issue is presented when the depositors of the trust company seek to gain control of the mortgages against which participating certificates have been issued to trusts,[38] and when a mortgagor who mortgaged real estate to the trust company in its corporate capacity desires to set off against his mortgage debt the amount of a deposit he may have had in the banking department of the trust company.[39]

35. Different types of trusts such as living trusts with or without the power of revocation and testamentary trusts may all have different needs and require different handling. Especially troublesome is the living trust with a power of revocation in the settlor. Cf. Roberts's Trust Estate, 316 Pa. 545, 175 Atl. 869 (1934).

36. Peters, *supra* note 11; Smith, *Commingled Trust Funds as a New Advance in Fiduciary Service* (1932) 54 TRUST CO. 593; cf. RIDDLE, loc. cit. *supra* note 2; Barclay, *Valuable Experience with Commingled Funds for Trust Estates* (1933) 56 TRUST CO. 183; BOGERT, loc. cit. *supra* note 2. This same problem is present to an even greater degree in the plans for common investment funds. In Delaware one trust company operates two separate common investment funds. The securities in one fund are all legal investments under the laws of Delaware, and trust funds are invested therein without any express permission from the settlor. The securities in the second fund are more general in nature, and trust funds are invested in it only with the permission of the settlor.

37. E.g., Matter of De Winter, 154 Misc. 50, 276 N. Y. Supp. 576 (Surr. Ct. 1934) (objections to accounting overruled and distribution of certificates permitted); Crick's Estate, 315 Pa. 581, 173 Atl. 327 (1934) (same); Osterling v. Commonwealth Trust Co., 181 Atl. 769 (Pa. 1935) (trustee ordered to pay in cash).

38. E.g., Gratzinger v. Arehart, 198 N. E. 787 (Ind. 1935) (holders of mortgage certificate, on which issuing bank was directly liable for principal and interest, held entitled to mortgages securing the certificates as against the receiver of the bank). The reverse of this situation has arisen where mortgage certificate holders have found it more to their advantage to come in as general creditors of the issuing bank or trust company because of the great depreciation in the value of the mortgages against which the certificates were issued. Ulmer v. Fulton, 129 Ohio St. 323, 195 N. E. 557 (1935); In re Manayunk Trust Co. (No. 2), 21 D. & C. 405 (Pa. C. P. 1934).

39. As a general rule the mortgagor-depositor is not entitled to set off the amount of

In any case in which the legality of the investment of trust funds in a participating mortgage of any type is questioned, the trust company which operated the participation device is of course always subject to the ordinary rules governing investments by trustees.[40] In those states where trustees are left to their discretion, a trustee must make only such investments as a reasonably prudent man would make of his own property, having in mind the preservation of the corpus of the trust and the probable income which the investment will yield. In the states where legal investments are prescribed by statute, a trustee is usually held to this same general standard of care.[41]

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his deposit against his mortgage debt when the mortgage has been declared to be held in trust for participating certificate holders. United States Bank & Trust Co. Case, 311 Pa. 320, 166 Atl. 871 (1933); In re Washington Trust Co., 16 Washington County 1 (Pa. C. P. 1935); cf. Lawrence v. Lincoln County Trust Co., 123 Me. 273, 122 Atl. 765 (1923). *Contra:* Ulmer v. Fulton, 129 Ohio St. 323, 195 N. E. 557 (1935). This latter case is much controverted and should be confined to its particular facts, especially in the light of the general practices of the litigant trust company. See Comment (1935) 9 U. OF CIN. L. REV. 490; (1936) 36 COL. L. REV. 314; (1935) 33 MICH. L. REV. 1113. But where a valid right of set-off was in existence at the time the trust company declared itself trustee of the mortgage for the certificate holders, the mortgagor-depositor is entitled to enforce that right. Gordon v. Anthracite Trust Co., 117 Pa. Super. 544, 178 Atl. 406 (1935); Kisinger v. Pennsylvania Trust Co., 180 Atl. 79 (Pa. Super. 1935).

40. Of course, where there are directions in the instrument creating the trust as to the types of investments which the trustee may make, such directions govern, regardless of the equitable or statutory rules. In the following cases investments in participation mortgage certificates were held to exceed the authority given in the instrument. Will of Mendel, 164 Wis. 136, 159 N. W. 806 (1916); Matter of Trimbey, 151 Misc. 37, 271 N. Y. Supp. 703 (Surr. Ct. 1934); Matter of Waxelbaum, 156 Misc. 45, 281 N. Y. Supp. 186 (Surr. Ct. 1935).

41. In this connection there have been two general rules laid down in different jurisdictions. For the so-called Massachusetts or liberal rule, see Harvard College v. Amory, 26 Mass. 446 (1830); Kimball v. Whitney, 233 Mass. 321, 123 N. E. 665 (1919). For the so-called New York or strict rule, see King v. Talbot, 40 N. Y. 76, 85, 86 (1869), where the court said that trustees are "bound to employ such diligence and such prudence in the care and management, as in general, prudent men of discretion and intelligence in such matters, employ in their own like affairs. This necessarily excludes all speculation." . . . "The preservation of the fund, and the procurement of a just income therefrom, are primary objects of the creation of the trust itself, and are to be primarily regarded." Cf. also In re Buhl's Estate, 211 Mich. 124, 178 N. W. 651 (1920), and Hart's Estate (No. 1), 203 Pa. 480, 53 Atl. 364 (1902), in which the statement of the rule is changed to a requirement of such diligence and prudence as a man would exercise who was trustee of the property of others. Recent cases applying the rule of King v. Talbot in the light of the New York statute are Guaranty Trust Co. v. Fisk, 244 App. Div. 200, 278 N. Y. Supp. 809 (1st Dep't, 1935); Matter of Leonard, 151 Misc. 558, 271 N. Y. Supp. 897 (Surr. Ct. 1934). That this rule still operates even where a particular type of investment is authorized by statute, see Matter of Sarah Blake's Estate, 146 Misc. 780, 263 N. Y. Supp. 310 (Surr. Ct. 1933); Matter of McKeough, 151 Misc. 327, 271 N. Y. Supp. 362 (Surr. Ct. 1934). Also, RESTATEMENT, TRUSTS (1935) § 227, comment p.; Statement of Principles of Trust Institutions, art. 3, § 3, reprinted in (1934) 58 TRUST CO. 712. To the effect that the New York statute, stating that investments shall be made at the "sole risk" of the trustee, does not make a trustee the guarantor of the safety of

At the present time, because of the superior facilities of corporate trustees for obtaining investment information, there is a slight tendency to hold them to this standard more strictly than the individual trustee.[42]

The application of this general duty of trustees to the investment of funds in participation mortgages requires the trust company which sets up a participation mortgage plan to investigate the property which is to be mortgaged to ascertain that its value affords a safe margin of security for the amount of funds invested, a margin which in many states is prescribed by statute.[43] While most trust companies which invest in real estate mortgages to any great extent have specialized mortgage loan departments with experienced real estate appraisers, it is often safer to have the real estate valued by independent appraisers. Since the margin of security must be maintained after the mortgage has been acquired, reappraisals should be made at stated intervals; and should the margin become inadequate, the mortgage must be replaced by another investment.[44] A second part of this general duty of trustees is to exercise prudence in diversifying the investments of each trust in order to minimize the risk of loss.[45] In such diversification the trust company should

investment of trust funds in participating mortgage certificates, Matter of Flint, 240 App. Div. 217, 269 N. Y. Supp. 470 (2d Dep't, 1934); aff'd mem., 266 N. Y. 607, 195 N. E. 221 (1935); cf. Matter of Staten Island Nat. Bank & Trust Co., 156 Misc. 330, 282 N. Y. Supp. 163 (Surr. Ct. 1935).

42. See Estate of Allis, 191 Wis. 23, 29, 209 N. W. 945, 947 (1926); Matter of Clark, 136 Misc. 881, 889, 242 N. Y. Supp. 210, 220 (Surr. Ct. 1930), mod. on other grounds, 257 N. Y. 132, 177 N. E. 397 (1931); National Trustees Co. v. General Finance Co., [1905] A. C. 373, 381; RESTATEMENT, TRUSTS (1935) § 227, comment d. But see Linnard's Estate, 299 Pa. 32, 39, 148 Atl. 912, 914 (1930).

43. The percentages of the amount of the value of the real estate up to which loans may be made by trust companies varies in different states, of which the following statutes are typical: COLO. ANN. STAT. (Mills, 1930) § 7946 (50%); Ind. Laws, 1933, c. 40, § 186 (c) (50%); MASS. ANN. LAWS (Lawyer's Co-op., 1935) c. 172, § 34 (60% improved real estate, 50% unimproved); N. Y. BANK. LAW (1935) § 188(7), N. Y. PERS. PROP. LAW (1935) § 21(1), N. Y. DEC. EST. LAW (1935) § 111(1) (66 2/3%); PA. STAT. ANN. (Purdon, 1935) tit. 20, § 801 (66 2/3%); W. VA. CODE (1931) c. 44, art. 6, § 2 (80%). RESTATEMENT, TRUSTS (1935) § 229. Cf. In re Haydock's Estate, 284 N. Y. Supp. 931 (Surr. Ct. 1935) (corporate trustee surcharged where amount of mortgage exceeded permissible percentage allowed by statute and terms of the will); Matter of Hammersley, 152 Misc. 903, 274 N. Y. Supp. 303 (Surr. Ct. 1934) (no surcharge where necessary margin existed at time investment was made).

44. The difficulties of trustees who fail to get adequate appraisals are illustrated by the case of Estate of Marguerite Hanson, 42 Dauphin County 13 (Pa. O. Ct. 1935); cf. Matter of Jones, 155 Misc. 315, 280 N. Y. Supp. 521 (Surr. Ct. 1935); RESTATEMENT, TRUSTS (1935) § 231.

45. Appeal of Dickinson, 152 Mass. 184, 25 N. E. 99 (1890) (individual trustee); Durant v. Crowley, 197 App. Div. 540, 189 N. Y. Supp. 385 (1st Dep't, 1921) (individual trustee invested more than one-half of trust fund in a single mortgage); Matter of Jacobs, 152 Misc. 139, 273 N. Y. Supp. 279 (Surr. Ct. 1934) (corporate trustee invested too much of trust funds in participating mortgage certificate issued by mortgage guaranty company); Matter of Harbeck, 142 Misc. 57, 254 N. Y. Supp. 312 (Surr. Ct. 1931) (entire fund in a single mortgage); RESTATEMENT, TRUSTS (1935) § 228. But see Matter of Balfe, 152 Misc. 739, 755, 274 N. Y. Supp. 284, 302 (Surr. Ct. 1934), where it was held as long as

consider the nature, purposes and size of the particular trust estate. Where the trust estate is only a few thousand dollars in amount, it has been held proper in some cases to invest the entire fund in a single participating certificate.[46] With respect to trusts of fixed duration, ordinarily the trust company should be careful not to invest in certificates secured by mortgages whose maturity date is long after the date of the termination of the trust, although it has been held that under the circumstances of a particular case such investments may be proper.[47] The marketability of the participating certificates is another element which the trust company should consider, especially where distribution to the beneficiaries must be in cash. However, by many courts the stability of an investment is regarded as of superior importance to marketability, and for this reason they have refused to find any breach of duty by trustees, even though the certificates are not salable.[48] Furthermore, the trust company must give due consideration to the limitations upon charges it may make for its services in operating a participation mortgage plan. While the trust company would seem entitled to charge the trusts with the costs of operation in addition to its reasonable compensation for acting as trustee of each separate trust, it is not entitled to make any profit from the administration of such an investment plan.[49] For this reason, if any charge

the trustee (an individual) remained within the statute, he could put all his "apples in one basket."

46. Matter of Adriance's Estate, 145 Misc. 345, 260 N. Y. Supp. 173 (Surr. Ct. 1932); Matter of Packard, 146 Misc. 65, 261 N. Y. Supp. 580 (Surr. Ct. 1932); Matter of Balfe, 152 Misc. 739, 274 N. Y. Supp. 284 (Surr. Ct. 1934). See Matter of Froelich, 150 Misc. 371, 375, 269 N. Y. Supp. 541, 546 (Surr. Ct. 1934), where Surrogate Wingate labeled as "ridiculous" the suggestion that the trustee should have diversified a trust fund of $1,000.

47. Held improper in Matter of Sarah Blake's Estate, 146 Misc. 780, 263 N. Y. Supp. 310 (Surr. Ct. 1933); Matter of Guenard, 149 Misc. 182, 266 N. Y. Supp. 770 (Surr. Ct. 1933). Where a trust company retained participating mortgage certificates for four years after its ward attained majority, it was held responsible for the loss. In re Giese's Estate, 180 Atl. 711 (Pa. Super. 1935). Where a trust company failed to sell the certificates at the termination of the trust, and thereby incurred a loss, it was held liable. Matter of Jacobs, 152 Misc. 139, 273 N. Y. Supp. 279 (Surr. Ct. 1934). Such investment was held proper under the circumstances in Matter of Turner, 156 Misc. 68, 281 N. Y. Supp. 452 (Surr. Ct. 1935); cf. Marczak v. Brooklyn City Rr. Co., 147 Misc. 399, 263 N. Y. Supp. 27 (Sup. Ct. 1932) (where the investment was held improper since the conservator disregarded the age of the child), rev'd mem., 237 App. Div. 841, 261 N. Y. Supp. 915 (2d Dep't, 1932), aff'd mem., 262 N. Y. 473, 188 N. E. 25 (1933). In an analogous situation where a trustee has made a lease of property extending beyond the date of the termination of the trust, some courts have held the lease proper as a necessary means of renting the premises profitably. Russell v. Russell, 109 Conn. 187, 145 Atl. 648 (1929); Sweeney v. Hagerstown Trust Co., 144 Md. 612, 125 Atl. 522 (1924); Comment (1924) 38 YALE L. J. 794.

48. Matter of Flint, 240 App. Div. 217, 269 N. Y. Supp. 470 (2d Dep't, 1934), aff'd mem., 266 N. Y. 607, 195 N. E. 221 (1935); Matter of Guenard, 149 Misc. 182, 266 N. Y. Supp. 770 (Surr. Ct. 1933); Matter of Jacobs, 152 Misc. 139, 273 N. Y. Supp. 279 (Surr. Ct. 1934); see Matter of Frazer, 150 Misc. 43, 50; 260 N. Y. Supp. 477, 484 (Surr. Ct. 1933), where Surrogate Delehanty stated that "stability and not liquidity is the desideratum in such an investment." RESTATEMENT, TRUSTS (1935) § 227, comment m.

49. Carey v. Safe Deposit & Trust Co., 178 Atl. 242 (Md. 1935); see Sanders v. Hall,

is to be made for administering the participation mortgage plan, the trust company should be careful, where, for example, a flat interest rate is paid on the participating certificates, to adjust that rate to the rate paid by the mortgagor so that the difference which goes to the trust company will not be so large as to suggest the inclusion of profit. In several states one-half of one per cent has been regarded by trust companies as a reasonable charge for the expense of operating a participation plan, and this rate has been approved by some courts.[50]

These foregoing elements of fiduciary duty are present in varying degrees in the case of every type of investment, whether participation mortgages are involved or not. More serious doubts as to the legality of this form of investment arise from certain factors inherent in the participation mortgage device itself which tend to violate certain fundamental equitable principles governing the conduct of trustees.[51] The first of these objections arises in those participation mortgage plans in which title to the mortgage or mortgages is taken in the corporate name of the trust company without any designation of its trust capacity. This method of acquiring mortgages violates the duty of a trustee to earmark trust property the moment it is acquired.[52] It has been argued that it is impracticable to attempt to list the names of all the participating trusts in the mortgage itself, and that even the trust company's taking the mortgage as trustee for various undisclosed trusts is objectionable on the ground that it raises a cloud on the title to the land in the eyes of title examiners and thus lessens its value in the real estate market.[53] However, it would seem that some designation of the trusteeship should always be made unless the trust company is expressly allowed by statute or by the trust instrument to take title in its own name.[54]

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74 F. (2d) 399, 406 (C. C. A. 10th, 1934); Scott, *The Trustee's Duty of Loyalty* (1936) 49 HARV. L. REV. 521, 559; RESTATEMENT, TRUSTS (1935) § 242. For the trustee's right to compensation generally, see BOGERT, op. cit. *supra* note 5, at §§ 974-979; for the amounts allowed in New York by statute, see NEW YORK SURROGATE'S COURT ACT § 285 and NEW YORK CIVIL PRACTICE ACT § 1548. ..

50. Bowden v. Citizen's Loan & Trust Co., 259 N. W. 815 (Minn. 1935); cf. Rems Estate, 15 Lehigh County 348 (Pa. O. Ct. 1932); Merion Title & Trust Co.-Huff Memorial Scholarship Fund, 23 Delaware County 557 (Pa. C. P. 1933).

51. For general treatments of these more serious objections, consult BOGERT, op. cit. *supra* note 5, at § 676; McKinney, *supra* note 5; Comments (1930) 7 N. Y. U. L. Q. REV. 950; (1932) 41 YALE L. J. 455.

52. Yost's Estate, 316 Pa. 463, 175 Atl. 383 (1934); Pedigo v. Pedigo's Committee, 247 Ky. 403, 57 S. W. (2d) 54 (1933); Matter of Harbeck, 142 Misc. 57, 254 N. Y. Supp. 312 (Surr. Ct. 1931); RESTATEMENT, TRUSTS (1935) § 179, comment d. Under certain exceptional circumstances, such as will benefit the estate, and where the trustee acts in good faith, it has been held that no liability ensues. Keen's Estate, 306 Pa. 363, 159 Atl. 713 (1932).

53. Record, 7, Springfield Safe Deposit & Trust Co. v. First Unitarian Society Case No. 478, Sup. Jud. Ct. Mass., Sept. Sitting, 1935.

54. Statutes permitting this are N. Y. BANK. LAW (1935) § 188 (7); PA. STAT. ANN. (Purdon, 1935) tit. 7, § 819-1109. The Pennsylvania statute has been interpreted to create an exception in the case of participation mortgages from the operation of the general rule. Guthrie's Estate, 182 Atl. 248 (Pa. 1936). However, where a trust company acquires

Closely akin to this duty to earmark trust property is the duty of a trustee to keep trust property separate both from its own property[55] and from the property of other trusts of which it is trustee.[56] This duty was originally imposed in order to call to account any individual trustee who had mingled trust property with his own individual property, thereby making identification of the trust property practically impossible. In some straight participation mortgages a trust company through its banking department may hold a partial interest in a mortgage, while the balance of the interest is held by its trust department as trustee for various trusts. In the mortgage pool the trust company nearly always retains an equity in the pool. This manner of investment may be regarded by the courts as a mingling of fiduciary funds with those of the trust company, and as such it violates the duty that trust property should be kept separate. The rule against mingling the funds of two separate trusts for the purposes of investment is not so well established as that against mingling trust funds with a trustee's individual funds. Thus it has been held that the necessity of finding secure investments and the convenient manner in which participation mortgages fill this need will justify a mingling of funds of separate trusts.[57] On the other hand, it has been argued that such mingling

mortgages through its banking department for future trust investments, they must be earmarked as such at the time of acquisition and within one year from that date must be utilized for trust investment purposes. It is also required that a monthly report be made to the state banking department of all such earmarked acquisitions. PA. STAT. ANN. (Purdon, 1935) tit. 7, § 819-1111.

55. De Jarnette v. De Jarnette, 41 Ala. 708 (1868); Estate of Hinkel, 218 Cal. 614, 24 P. (2d) 778 (1933); Alspaugh v. Adams, 80 Ga. 345, 5 S. E. 496 (1888); Pedigo v. Pedigo's Committee, 247 Ky. 403, 57 S. W. (2d) 54 (1933); First Nat. Bank of Paterson v. Jersey Central Power & Light Co., 115 N. J. Eq. 242, 170 Atl. 209 (Ch. 1934); Doud v. Holmes, 63 N. Y. 635 (1875); Re Edmund Hodges' Estate, 66 Vt. 70, 28 Atl. 663 (1894); see Duncan v. Williamson, 18 Tenn. App. 153, 160, 74 S. W. (2d) 215, 219 (1933); cf. Estate of Pfister, 216 Wis. 42, 255 N. W. 911 (1934); Estate of Wittwer, 216 Wis. 432, 257 N. W. 626 (1934). But cf. Estate of Sarment, 123 Cal. 331, 55 Pac. 1015 (1899); Graver's Appeal, 50 Pa. 189 (1865). RESTATEMENT, TRUSTS (1935) § 179, comment b.

56. Moore v. McKenzie, 112 Me. 356, 92 Atl. 296 (1914); Lannin v. Buckley, 256 Mass. 78, 152 N. E. 71 (1926); Heaton v. Bartlett, 180 Atl. 244 (N. H. 1935), noted in (1935) 10 TEMPLE L. Q. REV. 94; Fowler v. Colt, 25 N. J. Eq. 202 (Ch. 1874), aff'd, Salisbury v. Colt, 27 N. J. Eq. 492 (1875); McCullough's Executors v. McCullough, 44 N. J. Eq. 313, 14 Atl. 642 (Ch. 1888). Cf. the English cases on contributory mortgages: Webb v. Jonas [1887] 39 Ch. Div. 660; In re Dive [1909] 1 Ch. 328. These are distinguishable in that the trustee mingled his trust funds with those of a third person, thus giving up a portion of his control over the security. Where different trusts are created by the same instrument, rather than hold the trustee the courts may find that the instrument did not necessitate segregation. Titsworth v. Titsworth, 107 N. J. Eq. 436, 152 Atl. 869 (Ch. 1931); Matter of Kohler, 193 App. Div. 8, 183 N. Y. Supp. 550 (1st Dep't, 1920); Matter of Sidenberg, 147 Misc. 742, 264 N. Y. Supp. 704 (Surr. Ct. 1933). See arguments given in Matter of Union Trust Co., 86 Misc. 392, 149 N. Y. Supp. 324 (Surr. Ct. 1914), aff'd, 219 N. Y. 514, 114 N. E. 1057 (1916). For a statutory prohibition of the mingling of the funds of two trusts for investment purposes, see S. C. CODE (Michie, 1932) § 7909. RESTATEMENT, TRUSTS (1935) § 179, comment c, § 227, comment j.

57. Chesterman v. Eyland, 81 N. Y. 398 (1880); Barry v. Lambert, 98 N. Y. 300 (1885); Matter of Union Trust Co., 219 N. Y. 514, 114 N. E. 1057 (1916); Elkin v. Elkin,

prevents a trustee from administering each investment solely in the interest of a single trust, for the needs and desires of different trusts and their beneficiaries may conflict upon such questions as reductions in interest rates, extensions of time for payment, and foreclosures of mortgages. Moreover, it may prevent a proper allocation of losses and charges between the various trusts.[58] However, the practical possibility of a conflict between the interests of different trusts seems extremely remote except in very unusual cases.

In view of the fact that this duty to keep the property of each trust separate from all other property was one formulated for the individual trustee at a time when the modern corporate trustee with its complete bookkeeping and accounting facilities was unknown, it would seem that objections to the participation mortgage device on this score lose much of their force.[59] The application of this duty to the present situation is further weakened by the fact that by the issuance of participation certificates to each trust in addition to keeping complete and accurate bookkeeping records, the trust company makes possible an immediate identification of the interest of each trust at any time, thus satisfying the primary basis of the duty to keep trust property separate.[60]

The third and by far the most serious of the objections inherent in the nature of the participation mortgage device is the frequency with which it involves transactions partaking of the nature of a sale to or purchase from the banking department of the trust company by the trust company as trustee. To prevent his personal interest from conflicting with his obligation to admin-

29 Misc. 513, 61 N. Y. Supp. 947 (Sup. Ct. 1899); see Re Walker, 62 L. T. R. 449, 451 (Ch. Div. 1890); cf. Matter of Menzie, 54 Misc. 188, 105 N. Y. Supp. 925 (Surr. Ct. 1907); Nance v. Nance, 1 S. C. 209 (1869); Comment (1932) 41 YALE L. J. 455; 11 RULING CASE LAW 143.

58. BOGERT, op. cit. *supra* note 5, at § 676.

59. But see Matter of Union Trust Co., 219 N. Y. 514, 522, 114 N. E. 1057, 1059 (1916), where the court stated that "the identity of investment of trust funds should not . . . be wholly dependent upon the continuance of rules relating thereto by corporate trustees or the accuracy and honesty of bookkeepers and employees."

60. RESTATEMENT, TRUSTS (1935) § 227, comment j. A further argument is that in many states statutes have made the corporate bonds of railroad and public utility companies legal investments for trustees. These bonds are secured by a single mortgage to a trustee, so that while each bondholder has a separate promise of the obligor to pay, he has merely an undivided interest in the security. The courts have never found any objection on the grounds of mingling where a trustee has made such an investment. A certain analogy exists between such bonds and the situation presented in the mortgage certificate. BOGERT, op. cit. *supra* note 5, at § 676. A further tendency to permit a greater degree of commingling by corporate trustees is evidenced in the statutes and decisions of various states, permitting deposit of trust funds in a general fund in the trust company's banking department. Cf. Herzog v. Title Guarantee & Trust Co., 148 App. Div. 234, 132 N. Y. Supp. 1114 (1st Dep't, 1911), aff'd, 210 N. Y. 531, 103 N. E. 885 (1913); McDonald v. Fulton, 125 Ohio St. 507, 182 N. E. 504 (1932) and OHIO GEN. CODE (Page, 1926) § 710-165; also Hayward v. Plant, 98 Conn. 374, 119 Atl. 341 (1923); Commonwealth v. Tradesmen's Trust Co., 250 Pa. 378, 95 Atl. 577 (1915). The cases are discussed in Ex parte Michie, 167 S. C. 1, 165 S. E. 359 (1932). The practice was held improper in Glidden v. Gutelius, 96 Fla. 834, 119 So. 140 (1928). For general discussion, Whitmore, *Self-Deposit by Trust Companies of Fiduciary Funds* (1934) 12 N. C. L. REV. 350; Comment (1935) 48 HARV. L. REV. 1184.

ister a trust solely for the benefit of the beneficiaries, a trustee is under a duty of loyalty not to sell trust property to himself nor to sell his own property to the trust.[61] In setting up many straight participation mortgage plans, a trust company will first acquire the mortgage with its own funds, then declare itself trustee of the mortgage for certain of its trusts, and reimburse its banking department from the funds of those trusts for the initial expenditure. Subsequently, in the operation of such a participation mortgage plan, the trust company as trustee often sells to and buys from its banking department the participating certificates issued against the mortgage. Although not regarded by all trust companies as cases of sale or purchase, these types of transactions do possess certain of the characteristics of a sale or purchase, and have been regarded by some courts as such self-dealing as will constitute a breach of the trust company's duty of loyalty.[62] In the mortgage pool these incidents of a sale or purchase become more pronounced where the so-called "float" and the power of substitution are present. Since trust companies in several instances used the power of substitution as a means of unloading poor mortgages on their trusts, the power has been singled out as the target for most of the recent criticism of the mortgage pool.[63] While in actual practice the existence of the power of substitution leads to more frequent interdepartmental sales and purchases within the trust company and thus affords greater opportunities for manipulation by unscrupulous trustees, on purely legal grounds the sales and purchases of mortgages pursuant to this power are no more reprehensible than the sales and purchases of participating interests by one department to another. In effect, when the trust company substitutes one mortgage for another it has merely effected a partial change in the investment held for each trust, a change which would be legal were it not for the self-dealing. Hence, if statutory permission is given to trust companies to operate a participation mortgage plan by sales and purchases of certificates from one department to another, there would seem to be no reason for denying them the power of substitution, especially if the statute provides for strict supervision of these transactions by the state banking authorities. It would seem that a properly exercised power of substitution might be very advantageous to the trust, and the instances of manipulation could be cared for by a surcharge of the trustee in the individual case.

61. St. Paul Trust Co. v. Strong, 85 Minn. 1, 88 N. W. 256 (1901); Cornet v. Cornet, 269 Mo. 298, 190 S. W. 333 (1916); Davoue v. Fanning, 2 Johns Ch. 252 (N. Y. 1816); Fulton v. Whitney, 66 N. Y. 548 (1876); Matter of Long Island Loan & Trust Co., 92 App. Div. 1, 87 N. Y. Supp. 65 (2d Dep't, 1904); Matter of Peck, 152 Misc. 315, 273 N. Y. Supp. 552 (Surr. Ct. 1934); In re Guardianship of Lodge, 32 N. P. (N. S.) 40 (Ohio Prob. Ct. 1934); cf. Roberts v. Michigan Trust Co., 273 Mich. 91, 262 N. W. 744 (1935); Wendt v. Fischer, 243 N. Y. 439, 154 N. E. 303 (1926). Scott, *supra* note 49; RESTATEMENT, TRUSTS (1935) § 170.

62. Ulmer v. Fulton, 129 Ohio St. 323, 195 N. E. 557 (1935); In re Guardianship of Lodge, 32 N. P. (N.S.) 40 (Ohio Prob. Ct. 1934); cf. Matter of Thomson, 135 Misc. 62, 237 N. Y. Supp. 622 (Surr. Ct. 1929); Matter of Balfe, 152 Misc. 739, 274 N. Y. Supp. 284 (Surr. Ct. 1934), aff'd with modifications, 245 App. Div. 22, 280 N. Y. Supp. 128 (2d Dep't, 1935).

63. See cases cited in note 25, *supra*.

While not relevant to the situation in which a trust company issues participating certificates to its own trusts, other serious legal objections arise when a trust company or individual trustee invests trust funds in participating certificates issued by another trust company or a title insurance and mortgage company. The strongest of these objections is that such a method of investment involves an improper delegation of powers by the trustee.[64] Under most participation mortgage plans the trustee must surrender to the issuing company complete power to make all decisions arising in connection with the administration of the mortgage, and even in the absence of such provision in the plan, the trustee would seem dependent upon the issuer to ascertain whether the requisite margin of security is present at the time the investment is made and is maintained during the term of the investment. In the absence of a permissive statute or trust instrument, the rule against the delegation of such powers would invalidate investments made in this manner[65]

Possibly because these various legal objections may be raised to most participation mortgage plans notwithstanding their financial desirability under normal circumstances, corporate trustees have been expressly authorized by statutes of California, Indiana, New Jersey, New York, Oregon, Pennsylvania, Tennessee, Washington, Hawaii[66] and probably Vermont[67] to invest in participating mortgage certificates. In California, New York, Oregon, Pennsylvania, Tennessee, Washington and Hawaii trust companies are specifically empowered to issue such certificates against the security of a single mortgage to the trusts of which they may be trustees, or in other words to operate a straight participation mortgage plan.[68] In Indiana it would seem that this

64. For the general rule, cf. North American Trust Co. v. Chappell, 70 Ark. 507, 69 S. W. 546 (1902); Coleman v. Connolly, 242 Ill. 574, 90 N. E. 278 (1909); In re Iscovitz' Estate, 179 Atl. 548 (Pa. 1935); Meck v. Behrens, 141 Wash. 676, 252 Pac. 91 (1927); RESTATEMENT, TRUSTS (1935) § 171; BOGERT, op. cit. *supra* note 5, at §§ 554-557.

65. BOGERT, op. cit. *supra* note 5, at § 676; Will of Mendel, 164 Wis. 136, 159 N. W. 806 (1916); cf. Matter of Allen, 142 Misc. 113, 254 N. Y. Supp. 176 (Sup. Ct. 1931). This point of delegation is discussed at length in Gouley, *supra* note 6.

66. CAL. GEN. LAWS (Deering, 1931) tit. 50, § 104; Ind. Laws 1933, c. 40, § 186 (c); N. J. COMP. STAT. (Supp. 1930) tit. 72, § 37a; N. Y. BANK. LAW (1935) § 188 (7); N. Y. PERS. PROP. LAW (1935) § 21 (1), N. Y. DEC. EST. LAW (1935) § 111 (1); Ore. Laws 1935, c. 212, §§ 5, 6; PA. STAT. ANN. (Purdon, 1935) tit. 20, § 801 (7), tit. 7, § 819-1109; TENN. CODE ANN. (Williams, 1934) § 9596.3; WASH. REV. STAT. ANN. (Remington, 1932) § 3255 (l) (b); HAWAII REV. LAWS (1935) § 6910. In New York the Streit Committee has recently recommended drastic amendments of the respective permissive statutes so as to prohibit the use of the participation mortgage device by fiduciaries. Section 188 (7) of the Banking Law, in particular, would be altered so as to prohibit trust companies from distributing participating mortgage certificates to their trust estates, from transferring certificates from one trust to another, and from purchasing certificates from themselves. N. Y. Times, Feb. 24, 1936, at 25, col. 1.

67. VT. PUB. LAWS (1933) § 6816, which permits a trust company to "associate together for common investment the funds of individual trusts held by it whether created by order of court or otherwise, if the terms of the trust do not require a separate investment."

68. CAL. GEN. LAWS (Deering, 1931) tit. 50, § 104; N. Y. BANK. LAW (1935) § 188 (7); Ore. Laws 1935, c. 212, §§ 5, 6; PA. STAT. ANN. (Purdon, 1935) tit. 7, § 819-1109D; TENN. CODE ANN. (Williams, 1934) § 9596.3; WASH. REV. STAT. ANN. (Remington, 1932) §

power can be reasonably implied. In New Jersey the statute provides that the mortgage or trust deed against which the participating certificates are issued shall be deposited with another trust company, bank, or title guaranty company, thus apparently preventing the entire transaction from being carried on within a single trust company.[69] Express statutory authority to create mortgage pools exists only in Pennsylvania;[70] but although the implication of such a power is doubtful, trust companies in other states have operated pools.[71] In California, New York, Pennsylvania and Hawaii the statutes clearly confer the right to hold the mortgages in the corporate name of the trust company without designating any trust capacity.[72] In California, New York, Oregon, Pennsylvania and Hawaii the trust company has the statutory power to sell to and buy from its banking department in its trust capacity.[73] In Washington this power seems to be expressly denied.[74] The statutes of New York, Oregon, Pennsylvania and Hawaii require that the records of the trust company at all times show the separate interests of each trust; that of New Jersey requires the issuance of participating certificates to all parties interested in the mortgage.[75] In New York it is provided that notice must be given to the beneficiaries of each trust whenever an investment for that trust is made in participating mortgage certificates.[76] In New Jersey, New York, Oregon and Hawaii each

3255 (1) (b); HAWAII REV. LAWS (1935) § 6910. For the legislative history of N. Y. BANK. LAW (1935) § 188 (7), see Matter of Frazer, 150 Misc. 43, 268 N. Y. Supp. 477 (Surr. Ct. 1932).

69. N. J. COMP. STAT. (Supp. 1930) tit. 72, § 37a. However, at least one trust company did keep the whole transaction within the company by assigning the mortgage or trust deed to one of its own trust officers as trustee thereof for all the certificate holders.

70. PA. STAT. ANN. (Purdon, 1935) tit. 7, § 819-1109. For a similar act in reference to title insurance companies with trust company powers, see PA. STAT. ANN. (Purdon, 1930) tit. 15, § 2514. Prior to January 15, 1934, the Hawaii statute expressly sanctioned mortgage pools. Hawaii Laws 1931, p. 299, amending HAWAII REV. LAWS (1925) § 3484A. However, the amendment of January 15, 1934, has apparently removed this power. See HAWAII REV. LAWS (1935) § 6910.

71. In Indiana, New Jersey, New York, North Carolina and Ohio. For New York, cf. Matter of Union Trust Co., 219 N. Y. 514, 114 N. E. 1057 (1916); for Ohio, Ulmer v. Fulton, 129 Ohio St. 323, 195 N. E. 557 (1935), and Squire v. Central United Nat. Bank, Daily Legal News and Cleveland Recorder, Cleveland Ohio, Dec. 19, 1935, at 1.

72. CAL. GEN. LAWS (Deering, 1931) tit. 50, § 104; N. Y. BANK. LAW (1935) § 188 (7); PA. STAT. ANN. (Purdon, 1935) tit. 7, § 819-1109; HAWAII REV. LAWS (1935) § 6910.

73. CAL. GEN. LAWS (Deering, 1931) tit. 50, § 104; N. Y. BANK. LAW (1935) § 188 (7); Ore. Laws 1935, c. 212, §§ 5, 6; PA. STAT. ANN. (Purdon, 1935) tit. 7, § 819-1109; HAWAII REV. LAWS (1935) § 6910.

74. WASH. REV. STAT. ANN. (Remington, 1932) § 3255 (s).

75. N. Y. BANK. LAW (1935) § 188 (7); Ore. Laws 1935, c. 212, §§ 5, 6; PA. STAT. ANN. (Purdon, 1935) tit. 7, § 819-1109; HAWAII REV. LAWS (1935) § 6910; N. J. COMP. STAT. (Supp. 1930) tit. 72, § 37a.

76. N. Y. BANK. LAW (1935) § 188 (7); Matter of Roche, 245 App. Div. 192, 281 N. Y. Supp. 77 (4th Dep't, 1935) (trustee surcharged for failure to give notice); Matter of Peene, 155 Misc. 155, 279 N. Y. Supp. 131 (Surr. Ct. 1935) (same); Irving Trust Co. v. Natica, Lady Lister-Kaye, 284 N. Y. Supp. 343 (Surr. Ct. 1935) (notice given held timely under the circumstances).

certificate must be equal in lien to every other certificate issued against the mortgage.[77]

The most complete legislative pronouncement on participation mortgages at the present time is the Pennsylvania mortgage pool statute.[78] Under it a trust company is authorized to establish a pool of mortgages purchased solely with the funds of estates held by it as fiduciary. The trust company is to apportion fractional interests in the pool to the trust estates in proportion to the amounts of their respective contributions. The participating interests in the pool are to be held solely by the trust company as fiduciary and the equitable interests solely by the trust estates of which the trust company is fiduciary. Upon distribution of any trust estate its interests in the pool may be sold to another trust estate or to the banking department of the trust company, which afterwards may resell to another trust estate. Participating certificates need not be issued, since the records of the trust company must at all times show the names and interests of each trust estate. But if certificates are issued, the certificates must state that they are issued without guaranty and are payable only out of such funds as become available from the mortgages comprising the pool. The power to substitute mortgages is expressly granted.

Statutory authority for trustees to invest in split mortgages seems to have been given more freely than that for investment in straight participation mortgages. While never included in the statute *eo nomine* as are participating certificates, the split mortgage type of investment appears to be legal by the statutes of Colorado, Delaware, Indiana, Iowa, Minnesota, New Jersey, New York, Ohio, Oregon, Pennsylvania, Vermont, Virginia, West Virginia and Wisconsin, and may be implicitly authorized by the statutes of other states.[79]

Even in the absence of any statutory authority, corporate trustees in many other states have for a long time used participation mortgages as a means of investing their trust funds. Insofar as it has been possible to secure accurate information, the straight participation mortgage has been used in Alabama, Colorado, Connecticut, Delaware, Kentucky, Massachusetts, Minnesota, North Carolina, Ohio, Oklahoma, Rhode Island and possibly in other states,[80] as

77. N. Y. BANK. LAW (1935 § 188 (7); N. J. COMP. STAT. (Supp. 1930) tit. 72, § 37a; Ore. Laws 1935, c. 212, §§ 5, 6; HAWAII REV. LAWS (1935) § 6910.

78. PA. STAT. ANN. (Purdon, 1935) tit. 7, § 819-1109.

79. COLO. ANN. STAT. (Mills, 1930) § 7946; Del. Laws 1931, c. 259, § 1; Ind. Laws 1933, c. 40, § 186 (c); IOWA CODE (1931) § 12772 (5); MINN. STAT. (Mason, 1927) § 7714 (4); N. J. COMP. STAT. (Supp. 1930) tit. 72, § 37a; N. Y. PERS. PROP. LAW (1935) § 21 (1), N. Y. DEC. EST. LAW (1935) § 111 (1); OHIO GEN. CODE (Page, Supp. 1935) § 10506-41; Ore. Laws 1935, c. 212, §§ 5, 6; PA. STAT. ANN. (Purdon, 1935) tit. 20, § 801 (7); VA. CODE (Michie, Supp. 1934) § 5431; W. VA. CODE (1931) c. 44, art. 6, § 2; WIS. STAT. (1931) § 231.32. These statutes generally state that investments may be made in notes or bonds secured by a first mortgage or deed of trust of real estate. Other statutes, less clear in their import, merely state that investments may be made in "first mortgages." E.g. ILL. REV. STAT. (Cahill, 1935) c. 3, § 144; N. M. STAT. ANN. (1929) § 13-135. Another type authorizes investments in real estate "mortgage notes, bonds." KY. STAT. (Carroll, Supp. 1934) § 4706.

80. Of these states, insofar as it has been possible to secure information, participation mortgages are in use today as a medium of trust investment in Alabama, Massachusetts, Minnesota, North Carolina, and Rhode Island. They were used prior to the depression in

well as in those states where statutory permission has been granted. In other states it is probable that trust companies have purchased participating certificates from title insurance or mortgage guaranty companies.[81] The split mortgage device has been utilized in Alabama, Georgia, Illinois, Massachuusetts, Minnesota, Virginia, Wisconsin and very probably in numerous other states. In addition to Pennsylvania, mortgage pools have been created and operated by trust companies in Indiana, New Jersey, New York, North Carolina and Ohio.[82]

As mentioned previously, the amount of litigation involving the legality of the participation mortgage device has been constantly increasing since 1931. During 1935 and up to the present time in 1936 the highest courts of five states—Indiana, Minnesota, New York, Ohio and Pennsylvania—rendered opinions on questions involving various aspects of the participation mortgage device.[83] In the lower courts there was an even greater amount of such litigation.[84] In Massachusetts and Illinois, cases involving the legality of fiduciary investments in straight participation mortgages and split mortgages respectively have been argued and now await decision.[85] In the other states where participation mortgages have been used without their legality being as yet passed upon, it seems probable that the question will soon be raised.

In view of the high degree of uncertainty in so many states as to the legality of participation mortgages as a means for the investment of trust funds, it is extremely desirable that their use be either approved or disapproved by the legislatures of the various states. If real estate mortgages regain their

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Connecticut, Delaware, Kentucky, and Oklahoma. In Colorado the practice was discontinued in some cases at the instigation of national banking authorities. In Wisconsin participation mortgages were used prior to 1913, but they fell into disrepute in that state because of the failure of a large trust company which had made extensive use of them. They have never been used in Georgia, Iowa, Louisiana, Maryland, South Carolina, or Texas. In Michigan participating mortgage certificates have been sold to the public by trust companies, but apparently have never been used as a method of trust investment.

81. Generally it seems that a trust company prefers to issue participating certificates against mortgages which it holds itself, rather then to buy guaranteed certificates from title insurance or mortgage companies "because of the greater familiarity with the security and because of faith in its own appraisals." Matter of Flint, 240 App. Div. 217, 220, 269 N. Y. Supp. 470, 474 (2d Dep't, 1934). Also, Record, 14, Springfield Safe Deposit & Trust Co. v. First Unitarian Society, Case No. 478, Sup. Jud. Ct. Mass., Sept. Sitting, 1935.

82. In Illinois, the case of Matter of Estate of Lalla, involving the legality of investments by guardians and conservators in split mortgages, is now pending before the Illinois Supreme Court. The Appellate Court, First District, held the investments legal in an opinion rendered July 5, 1935. Apparently *contra* to this holding is the decision of the Appellate Court, Third District, in the case of In re Guardianship of Lutz, 280 Ill. App. 587 (1935); cf. In re Estate of Sargent, 276 Ill. App. 312 (1935).

83. Gratzinger v. Arehart, 198 N. E. 787 (Ind. 1935); Bowden v. Citizens' Loan & Trust Co., 259 N. W. 815 (Minn. 1935); Matter of Flint, 266 N. Y. 607, 195 N. E. 221 (1935) (mem. decision); Ulmer v. Fulton, 129 Ohio St. 323, 195 N. E. 557 (1935); Guthrie's Estate, 182 Atl. 248 (Pa. 1936).

84. See lower court cases from Ohio, New York and Pennsylvania cited *supra*.

85. In the Matter of the Estate of Lalla, Sup. Ct. of Ill.; Springfield Safe Deposit & Trust Co. v. First Unitarian Society, Sup. Jud. Ct. Mass. The investment in the latter case was held valid in an opinion filed Feb. 27, 1936.

former position as a prime medium of investment, it would seem that the utility of the participation mortgage device sufficiently outweighs its defects to justify statutory sanction of its use, especially since it is possible to frame the statutes in the light of the weaknesses of the device which have been revealed during the depression.[86] While certain incidents of the participation mortgage device afford opportunities for manipulation by unscrupulous fiduciaries, it would seem unreasonable to condemn an entire class of investments for the sole reason that a few trustees have used it to their own advantage. The courts and legislatures should recognize that a reasonable reliance must be placed in the honesty and integrity of fiduciaries,[87] and should seek to safeguard the beneficiaries of trusts by requiring the strictest sort of supervision of the investment policies of trust companies by the banking authorities, rather than by restricting further the already too narrow field of investments.

Mere legislative permission for corporate trustees to invest in participation mortgages would not in itself be sufficient. In the statutes of those states which at the present time make such a grant, aside from California, New York and Pennsylvania, so much is left to implication that the degree of uncertainty is almost as great as if there were no statutes at all.[88] Hence, the type of statute which should be enacted would be one prescribing in detail the manner of creating and operating the straight participation mortgage or the mortgage pool or both. Such detailed provisions should include specifications as to the types of institutions which may become the issuers of participating certificates. Insofar as trust companies are concerned, both the sale of certificates to the public and the guaranty of the payment of the certificates by the trust company, should be forbidden. It should be clearly indicated whether the trust company may hold mortgages in its corporate capacity or solely as trustee, and whether it may engage in those interdepartmental transactions, involving the sale or purchase of participating interests, which may be regarded as self-dealing. Where the mortgage pool is sanctioned and also the exercise of the power of substitution, it may be deemed desirable in the light of recent experi-

86. In New York, however, on the basis of the report of the Streit Committee, it has been recommended that the participation mortgage device be prohibited as a method of trust investment for both corporate and individual fiduciaries. The Streit Committee found that from 1928-1935, $283,569,603 had been invested by fiduciaries in participation mortgages, 45% of which are now in default; that many mortgages were placed on properties without proper appraisals or even inspections; and that many trust companies had been forced into the real estate business of managing and servicing mortgaged properties. On the other hand it should be pointed out that no investigation was made of the investment of funds of single trusts in whole mortgages, of which possibly a comparable amount may be in default. Moreover, no distinction seems to have been made between the situation where a trust company issued the certificates, and that where it purchased them from a mortgage guaranty company. N. Y. Times, Feb. 24, 1936, at 25, col. 1; N. Y. Herald Tribune, Feb. 24, 1936, at 21, col. 6. See note 66, *supra*.

87. See Bowden v. Citizens' Loan & Trust Co., 259 N. W. 815, 818 (Minn. 1935).

88. Even in New York and Pennsylvania there has been a great amount of litigation over the interpretation of these statutes. In some cases litigation seems to have arisen solely from an unwillingness on the part of beneficiaries to accept the language of the legislatures at its face value.

ence to require that when substitutions are made they should be reported to the banking authorities. Finally, some provision should be made to require the utmost care and prudence in making appraisals of the real estate upon which mortgages are to be placed, for the success or failure of any type of mortgage investment depends ultimately on the accuracy of these valuations.[89]

USE OF MILITARY FORCE IN DOMESTIC DISTURBANCES

The disorder which commonly attends industrial conflicts has, with increasing frequency, furnished occasion for the exercise by the Governor of his power to call forth the military forces of the State for the purpose of maintaining security of life and property.[1] While employment of the militia to this end is purely an administrative function, it has frequently given rise to justiciable controversies which courts have been forced to decide. The result has been the development of a branch of administrative law which has rarely been recognized as falling within that category. A survey of this field concerns itself with the effect of the Governor's resort to military action, the limits which courts have placed upon that action, and the liability of the Governor and members of the militia for acts which exceed those limits.

I

Within the exclusive discretion of the Executive, as the officer charged with the duty of executing the laws,[2] has been vested the determination of whether or not a situation has arisen which demands the summoning of troops.[3] His

89. In New York City where the guaranteed participation mortgage certificates were so common, practically all the difficulties existing today can be traced to improper appraisals or appraisals based on the hope of an ever-continuous rise in real estate values. This is clearly brought out in the reports of the Moreland investigation in the New York Times during 1934 and 1935. See also Comment (1934) 34 COL. L. REV. 663.

1. By the Constitutions of most states, the Governor is the Commander-in-Chief of the militia, which he may call out to execute the laws, to suppress insurrection, and to repel invasion. STIMSON, AMERICAN STATUTE LAW (1886) §§ 297, 298. See, e.g., In re Advisory Opinion to Governor, 74 Fla. 92, 77 So. 87 (1917).

For the common-law duty of magistrates to quell riots and rebellions by the use of military force, see Case of Armes, Pop. 121 (1597); Rex v. Kennett, 5 Car. & P. 282 (1781); Rex v. Pinney, 5 Car. & P. 254 (1832).

2. STIMSON, op. cit. *supra* note 1, § 280.

3. See Martin v. Mott, 25 U. S. 19, 30 (1827); Cox v. McNutt, 12 F. Supp. 355, 358 (S. D. Ind. 1935), noted (1936) 34 MICH. L. REV. 417; In re Moyer, 35 Colo. 159, 164, 165, 85 Pac. 190, 192 (1905); Franks v. Smith, 142 Ky. 232, 238, 134 S. W. 484, 487 (1911); In re McDonald, 49 Mont. 454, 460, 143 Pac. 947, 949 (1914); Hartranft's Appeal, 85 Pa. St. 433 (1877); State v. Brown, 71 W. Va. 519, 524, 77 S. E. 243, 246 (1912). Thus, a court cannot make a determination in advance that troops are necessary to quell an insurrection. Consolidated Coal & Coke Co. v. Beale, 282 Fed. 934 (S. D. Ohio, 1922). Nor can it command the executive branch of the state government to perform the duties imposed upon it in this respect. Strutwear Knitting Co. v. Olson, No. 2909 Eq. (D. Minn. Feb. 5, 1936).

decision is ordinarily regarded as conclusive by the courts.[4] Otherwise, it is said, the legality of executive orders would depend not upon the executive judgment, but upon that of a co-ordinate branch of government.[5]

In practice, however, while courts have purported to accept the Governor's declaration as final, they have often reviewed the evidence upon which it is based where the legality of his action, taken pursuant thereto, is in question.[6] Thus, a Federal District Court, examining into the arrest and detention of a striker by the militia, paid lip service to the doctrine that the court cannot inquire into the degree of necessity for troops or substitute its judgment for that of the Governor. Nevertheless, it proceeded to find that the strike situation was effectively handled by the state police without the aid of troops, and discharged the prisoner from a military arrest.[7] Similarly, notwithstanding a Governor's proclamation that a state of insurrection existed in the Texas oil fields in 1932, the United States Supreme Court, while adhering to the proposition that the Executive's finding of an exigency requiring military aid is conclusive, discovered no evidence of disturbance or riot, and, accordingly, denied the existence of any occasion which would justify the particular military action complained of.[8]

But although courts examine the facts to see, not whether they justify the Governor's *determination*, but only whether they justify his *action*, the practical effect in many cases is to nullify the proposition that the Executive decision is not subject to judicial review.[9] This subtlety of reasoning results in part from the fact that the Governor's call to the militia is often embodied in a so-called proclamation of "martial law."[10] While the proclamation may be a potent

4. See Moyer v. Peabody, 212 U. S. 78, 83 (1908); Powers Mercantile Co. v. Olson, 7 F. Supp. 865, 868 (D. Minn. 1934); In re Boyle, 6 Idaho 609, 612, 57 Pac. 706, 707 (1899); Ela v. Smith, 71 Mass. 121, 136, 137 (1855); Hearon v. Calus, 183 S. E. 13, 20 (S. C. 1935); Druecker v. Salomon, 21 Wis. 621, 630 (1867); and see cases cited *supra* note 3.

5. In re Moyer, 35 Colo. 159, 165, 85 Pac. 190, 192 (1905); Franks v. Smith, 142 Ky. 232, 238, 134 S. W. 484, 487 (1911).

6. See Constantin v. Smith, 57 F. (2d) 227 (E. D. Tex. 1932), aff'd, Sterling v. Constantin, 287 U. S. 378 (1932); Cox v. McNutt, 12 F. Supp. 355 (S. D. Ind. 1935); Powers Mercantile Co. v. Olson, 7 F. Supp. 865 (D. Minn. 1934); United States v. Adams, 26 F. (2d) 141 (D. Colo. 1927); Hearon v. Calus, 183 S. E. 13 (S. C. 1935); Druecker v. Salomon, 21 Wis. 621, 631 (1867); cf. Betty v. State, 188 Ala. 211, 66 So. 457 (1914).

7. United States v. Adams, 26 F. (2d) 141 (D. Colo. 1927).

8. Sterling v. Constantin, 287 U. S. 378 (1932), aff'g Constantin v. Smith, 57 F. (2d) 227 (E. D. Tex. 1932); cf. Hearon v. Calus, 183 S. E. 13, 21 (S. C. 1935): "It is common knowledge that in the area where a state of insurrection was said to exist, the militia was called out and martial law declared, all was as calm, quiet and peaceful as a May morn."

9. Where the only action for which the troops have been called out is enjoined, the Governor's determination that an exigency requires military action is, in effect, reviewed and reversed by the court. See, e.g., Constantin v. Smith, 57 F. (2d) 227 (E. D. Tex. 1932); Russell Petroleum Co. v. Walker, 162 Okla. 216, 19 P. (2d) 582 (1933); Hearon v. Calus, 183 S. E. 13 (S. C. 1935); Fairman, *Martial Rule in the Light of Sterling v. Constantin* (1933) 19 CORN. L. Q. 20, 33; Note (1936) 34 MICH. L. REV. 417, 418.

10. The statutes of only two states provide for a gubernatorial proclamation of martial law. MO. STAT. ANN. (Vernon, 1932) § 13825; UTAH REV. STAT. ANN. (1933) 54-1-8. The

incantation, it is, nevertheless, devoid of legal effect by itself.[11] It neither enlarges the powers of the Governor or the military authorities which he summons, nor alters the legal rights and obligations of the citizens within the territory proclaimed.[12] Being a mere formula of words, the proclamation itself can neither be inquired into nor enjoined.[13]

The designation "martial law" has served to obfuscate the legal principles which govern present day gubernatorial exertion of the military power. Historically, martial law included (1) the articles of war, enforced by courts-martial, regulating the military and naval forces of the government,—termed military law,[14] and (2) the administration by military forces of foreign territory occupied in time of war—termed military government.[15] It has long been established that martial law in the sense of military law is solely for the internal regula-

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statutes of most states, however, provide that whenever the militia is employed, the Governor, if in his judgment the maintenance of law and order will thereby be promoted, may by proclamation declare the county or city in which the troops are serving to be in a "state of insurrection." See, e.g., CALIF. POL. CODE (Deering, 1932) § 1917; NEB. COMP. STAT. (1929) c. 55, § 152; N. Y. MIL. LAW (1917) § 13.

11. Ex parte Lavinder, 88 W. Va. 713, 108 S. E. 428 (1921), noted (1921) 35 HARV. L. REV. 338. But note that this same court in two previous cases [State v. Brown, 71 W. Va. 519, 563, 77 S. E. 243, 262 (1912); Ex parte Jones, 71 W. Va. 567, 590, 77 S. E. 1029, 1039 (1913)] distinguished Franks v. Smith, 142 Ky. 232, 134 S. W. 484 (1911) and Ela v. Smith, 71 Mass. 121 (1855) upon the ground that they did not arise under proclamations of "war."

See 3 WILLOUGHBY, CONSTITUTIONAL LAW (1929) 1591. The British view is similar. Tilonko v. Attorney-General of the Colony of Natal (1907) A. C. 93, 94; Dodd, *The Case of Marais* (1902) 18 L. Q. REV. 143, 145.

Some courts have said that "martial law" prevailed notwithstanding the absence of a proclamation to that effect. In re Boyle, 6 Idaho 609, 57 Pac. 705 (1899); Commonwealth v. Shortall, 206 Pa. 165, 55 Atl. 952 (1903). Others have enjoined military measures notwithstanding the promulgation of a martial law proclamation. Ex parte Lavinder, *supra;* and cases cited *supra* note 9. But see United States v. Adams, 26 F. (2d) 141 (D. Colo. 1927), where the court said, at page 144: "If the Governor here had declared martial law, we would have an entirely different situation."

12. See 1 STEPHEN, HISTORY OF THE CRIMINAL LAW (1883) 214; Holdsworth, *Martial Law Historically Considered* (1902) 18 L. Q. REV., 117, 129. The only value of a martial law proclamation would appear to rest in some supposed emotional effect upon the public. See Arnold, *Martial Law* (1933) 10 ENCYC. SOC. SCIENCES, 162, 163.

13. See Hearon v. Calus, 183 S. E. 13, 20 (S. C. 1935).

14. See HALE, HISTORY OF THE COMMON LAW (Runnington's ed. 1820) 42: "For always, preparatory to an actual war, the kings of this realm . . . were used to compose a book of rules and orders for the due order and discipline of their officers and soldiers, together with certain penalties on the offenders; and this was called martial law." See further 1 BL. COMM. 413; CLODE, MILITARY AND MARTIAL LAW (1874) c. 1; DAVIS, MILITARY LAW (3d ed. 1913) c. 1 and 2; Pollock, *What is Martial Law?* (1902) 18 L. Q. REV. 152; Holdsworth, loc. cit. *supra* note 12.

15. See 2 HARE, AMERICAN CONSTITUTIONAL LAW (1889) 930, 944, 949; 2 WINTHROP, MILITARY LAW (1886) 18 et seq., and 37 et seq.; BIRKHIMER, MILITARY GOVERNMENT AND MARTIAL LAW (3d ed. 1914) c. 1 and 2. Note that none of the instances of "martial law" cited by these authorities have their locus within the United States or England.

Military government has been aptly designated "the law of hostile occupation." DAVIS,

tion of the army, and can never be extended over non-military persons.[16] Military government, on the other hand, knows no distinction between soldier and civilian; it applies alike to all persons within the territory subject to its dominion.[17] A concomitant of war, it is generally recognized as depending upon the mere arbitrary will of the military commander in the field, exercised according to the laws and usages of war.[18] It received its most extensive application in this country during the occupation by Union Forces of the Southern States in the Civil War. As the Union Army penetrated into the South, substitutes for the hostile civil governments which it overthrew were necessary; and as no power was left but the military, it was allowed to govern by martial law.[19]

Use of the same phrase to describe the current employment of military force to abate *domestic* disorder has led some courts to equate the disturbance occasioning the summoning of troops with a state of international war.[20] Civil war precedents for martial rule[21] are relied upon to analogize the power of the Governor and the State militia over a local district to the war-time power of the President and the Federal troops over the territory of the invaded South.[22] Constitutional guarantees in the affected area are said to be abrogated,[23] the status of belligerency is attached to the citizens therein,[24] and the will of the Governor, as the military chief, is exalted as the controlling authority in the theater of "war."[25]

MILITARY LAW (3d ed. 1913) 300. See discussion of martial law in New Orleans after its capture by Union forces in 1862. Dow v. Johnson, 100 U. S. 158 (1879).

16. "For others who had not listed with the army, had no colour or reason to be bound by military constitutions, applicable only to the army, whereof they were not parties." HALE, loc. cit. *supra* note 14. Wise v. Withers, 7 U. S. 331 (1806); In re Reynolds, Fed. Cas. No. 11,721 at 592 (N. D. N. Y. 1867); Smith v. Shaw, 12 Johns. 257 (N. Y. 1815).

Several state constitutions declare that no person shall be subjected to "martial law" except the army, navy, or militia in active service. STIMSON, op. cit. *supra* note 1, § 293.

17. See United States v. McDonald, 265 Fed. 754, 761 (E. D. N. Y. 1920).

18. See United States v. Diekelman, 92 U. S. 520, 526 (1875); In re Egan, Fed. Cas. No. 4,303, at 367 (C. C. N. D. N. Y. 1866); 8 Op. Att'y-Gen. 365, 369 (1857).

19. See Dow v. Johnson, 100 U. S. 158 (1879); Ex parte Milligan, 71 U. S. 2, 127 (1866); 2 WINTHROP, MILITARY LAW (1886) 46 et seq.

20. United States v. Fischer, 280 Fed. 208 (D. Neb. 1922); State v. Brown, 71 W. Va. 519, 77 S. E. 243 (1912); Ex parte Jones, 71 W. Va. 567 (1913); cf. Regina v. Frost, 9 Car. & P. 129 (1839).

21. Dow v. Johnson, 100 U. S. 158 (1879); United States v. Diekelman, 92 U. S. 520 (1875); New Orleans v. Steamship Co., 87 U. S. 387 (1874); The Grapeshot, 76 U. S. 129 (1869); In re Egan, Fed. Cas. No. 4,303, at 367 (C. C. N. D. N. Y. 1866). None of these cases deals with *state* power.

22. See, e.g., Ex parte Jones, 71 W. Va., 567, 574, 594, 77 S. E. 1029, 1032, 1041 (1913).

23. See State v. Brown, 71 W. Va. 519, 521, 522, 77 S. E. 243, 244 (1912).

24. See Ex parte Jones, 71 W. Va. 567, 605, 606, 77 S. E. 1029, 1045 (1913).

25. See United States v. Fischer, 280 Fed. 208, 210 (D. Neb. 1922); State v. Brown, 71 W. Va. 519, 521, 77 S. E. 243, 244 (1912). State v. Swope, 38 N. M. 53, 28 P. (2d) 4 (1933), and Commonwealth v. Shortall, 206 Pa. 165, 55 Atl. 952 (1903) would also seem to support this view. Cf. the British cases which hold that once a state of war justifying martial law is established to the court's satisfaction, it has no jurisdiction, *durante bello*, to interfere with the action of the military authorities. Rex (Garde) v.

Other courts, attacking as pernicious any doctrine involving the suspension of the Constitution and the supremacy of the military power, refuse to recognize that "martial law" in the above sense can have any lawful existence within the confines of states adhering to the National Government.[26] The Executive is held to summon the militia merely as a sort of supplementary police in order to aid the civil administration in the execution of the laws.[27] Only under the civil authority do the troops act, with no more power than the law gives to regularly constituted peace officers.[27] Military measures are held at all times subject to judicial review and injunction.[28]

The extreme war-time theory of executive military action has been the subject of severe criticism.[29] Domestic "insurrection" is not

Strickland, [1921] 2 Ir. Rep. 317; Ex parte Marais [1902] A. C. 109. But see Egan v. General Macready [1921] 1 Ir. Rep. 265; The King (O'Brien) v. Military Governor [1924] 1 Ir. Rep. 32. Note that the *locus in quo* of none of these cases is within the realm of England, and that the early English cases dealing with the duty of magistrates to quell riots and rebellions by military force within the realm of England did not talk in terms of "war" or "martial law." See cases cited *supra* note 1.

26. Ex parte Milligan, 71 U. S. 2, 120-126 (1866); Constantin v. Smith, 57 F. (2d) 227, 236, 237 (E. D. Tex. 1932); Bishop v. Vandercook, 228 Mich. 299, 200 N. W. 278 (1924); Franks v. Smith, 142 Ky. 232, 242, 243, 134 S. W. 484, 488 (1911). Still other courts have left the question open. Powers Mercantile Co. v. Olson, 7 F. Supp. 865 (D. Minn. 1934); In re Moyer, 35 Colo. 159, 169, 85 Pac. 190, 194 (1905). But see Chase, C. J., concurring, in Ex parte Milligan, 71 U. S. 2, 132 (1886).

27. See Constantin v. Smith, 57 F. (2d) 227, 238 (E. D. Tex. 1932); County of Christian v. Merrigan, 191 Ill. 484, 61 N. E. 479 (1901); Ela v. Smith, 71 Mass. 121, 140 (1855); Bishop v. Vandercook, 228 Mich. 299, 200 N. W. 278 (1924); Allen v. Gardner, 182 N. C. 425, 427, 109 S. E. 260, 261 (1921); In re Smith, 14 N. P. (N. S.) 497 (Com. Pl. Ohio 1913); State v. Coit, 8 Ohio Dec. 62 (Com. Pl. 1898); cf. In re Moyer, 35 Colo. 159, 85 Pac. 190 (1905); In re McDonald, 49 Mont. 454, 462, 143 Pac. 947, 951 (1914). But see State v. Swope, 38 N. M. 53, 28 P. (2d) 4 (1933); Commonwealth v. Shortall, 206 Pa. 165, 55 Atl. 952 (1903).

The statutes authorizing the Governor to order out the militia generally provide that they be called out "in aid of the civil authorities." See, e.g., COLO. ANN. STAT. (Mills, 1930) § 4813; ILL. REV. STAT. ANN. (Smith-Hurd, 1934) c. 129, § 194; LA. GEN. STAT. (Dart, 1932) § 4574; N. Y. MIL. LAW (1916) § 115.

28. Constantin v. Smith, 57 F. (2d) 227 (E. D. Tex. 1932); aff'd, Sterling v. Constantin, 287 U. S. 378 (1932); Strutwear Knitting Co. v. Olson, No. 2909 Eq. (D. Minn. Feb. 5, 1936); Cox v. McNutt, 12 F. Supp. 355 (S. D. Ind. 1935); United States v. Adams, 26 F. (2d) 141 (D. Colo. 1927); Hearon v. Calus, 183 S. E. 13 (S. C. 1935); Allen v. Oklahoma City, 52 P. (2d) 1054 (Okla. 1935); Russell Petroleum Co. v. Walker, 162 Okla. 216, 19 P. (2d) 562 (1933). See Ex parte Moore, 64 N. C. 802, 808 (1870); In re Kemp, 16 Wis. 359, 371 (1863).

29. See ex parte Milligan, 71 U. S. 2, 120-126 (1866); Constantin v. Smith, 57 F. (2d) 227, 240, 241 (E. D. Tex. 1932); In re McDonald, 49 Mont. 454, 474, 476, 143 Pac. 947, 953, 954 (1914); Bishop v. Vandercook, 228 Mich. 299, 309, 200 N. W. 278, 281 (1924); Woodbury, J., dissenting, in Luther v. Borden, 48 U. S. 1, 48 (1849); Steele, J., dissenting, in re Moyer, 35 Colo. 159, 170, 85 Pac. 190, 194 (1905); Robinson, J., dissenting, in State v. Brown, 71 W. Va. 519, 527, 77 S. E. 243, 247 (1912); Ex parte Jones, 71 W. Va. 567, 609, 77 S. E. 1029, 1047 (1913); Hatfield v. Graham, 73 W. Va. 759, 774, 81 S. E. 533, 539 (1914). See further 3 WILLOUGHBY, CONSTITUTIONAL LAW (1929) 1606; FAIRMAN, LAW OF MARTIAL RULE (1930) 152-157; Ballantine, *Unconstitutional Claims of*

war.[30] War is an act of sovereignty, which makes enemies of the inhabitants of the contending states, and creates the rights and duties of belligerency.[31] Insurrection, on the other hand, lacks political form, and does not change the legal relations between its participants and the government.[32] Moreover, doubts have been expressed whether a state may wage war at all.[33] On the other hand, the theory which restricts military power over domestic disturbances to that of civil peace officers has been said to be more in accord with state constitutional provisions that the military shall be forever subordinate to the civil authority.[34]

II

But however at variance with one another these theories may be, they seem to break down upon analysis into merely two divergent methods of reasoning by which courts reach similar results. All courts start from the premise that it is necessity which alone justifies gubernatorial military action.[35] As to the measures which may be taken for abatement of the disturbance or the preservation of order the Governor is allowed a wide range of discretion.[36] Those

Military Authority (1914) 24 YALE L. J. 189; Note (1921) 5 MINN. L. REV. 540. But see Shumaker, *Martial Law to Suppress Domestic Disorder* (1923) 26 L. NOTES 225; Wallace, *Martial Law* (1917) 8 JOUR. CRIM. L. 167.

30. See In re McDonald, 49 Mont. 454, 474, 143 Pac. 947, 953 (1914); Woodbury, J., dissenting, in Luther v. Borden, 48 U. S. 1, 48, 70, 75 (1849); Fairman, *Martial Rule and Suppression of Insurrection* (1929) 23 ILL. L. REV. 766, 770.

31. See Dow v. Johnson, 100 U. S. 158, 164 (1879); United States v. Dieckelman, 92 U. S. 520, 525 (1875).

32. See In re McDonald, 49 Mont. 454, 474, 143 Pac. 947, 953 (1914). Here analogy to the Civil War fails. The Southern States set themselves up as a separate political entity and were recognized as such. They were granted belligerent rights; the people of the Union and those of the Confederacy became enemies to each other; and commercial intercourse between them was prohibited. Thus the territory embraced by the Confederacy cannot be said to have been domestic. See Dow v. Johnson, 100 U. S. 158, 164 (1879); Prize Cases 67 U. S. 635 (1862).

33. See U. S. CONST. Art. I, § 10; Commonwealth v. Blodgett, 53 Mass. 56, 81, 82 (1846); Underhill, *Jurisdiction of Military Tribunals* (1924) 12 CALIF. L. REV. 75, 159, 168 et seq. At least one state has held that the Federal Government alone may recognize belligerent rights. Price v. Poynter, 64 Ky. 387 (1866); Bell v. Louisville and Nashville Rr. Co., 64 Ky. 404 (1866).

34. STIMSON, op. cit. *supra* note 1, § 292. In one state, martial law, "in the sense of the unrestricted power of military officers or others, to dispose of the persons, liberties or property of the citizen," is declared to be "inconsistent with the principles of free government, and is not confided to any department" of the state government. TENN. CONST. Art. I, § 25.

35. See, e.g., Hatfield v. Graham, 73 W. Va. 759, 767, 81 S. E. 533, 536 (1914); Druecker v. Salomon, 21 Wis. 621, 630 (1867); 8 Op. Att'y-Gen. 365, 374 (1857).

Analogy has been made to the common law right of an individual to self-defense. See In re Boyle, 6 Idaho 609, 612, 57 Pac. 706, 707 (1899); State v. Brown, 71 W. Va. 519, 521-523, 77 S. E. 243, 244 (1912).

36. See e.g., Cox v. McNutt, 12 F. Supp. 355, 360 (S. D. Ind. 1935); Powers Mercantile Co. v. Olson, 7 F. Supp. 865, 868 (D. Minn. 1934); State v. Swope, 38 N. M. 53, 57, 28 P. (2d) 4, 7 (1933).

measures which courts find reasonably necessary and substantially related to the attainment of that object are upheld, either upon a direct assignment of these grounds,[37] or upon the theory that the court cannot interfere with the controlling authority of the Executive, as the military chief.[38] On the other hand, where courts can discover no necessity to justify the military measures undertaken, such action is enjoined, either for the reason that it is beyond the constitutional power of the Governor[39] or violates due process of law,[40] or, where the court has adopted the war-time military government approach, upon the ground that there is no actual "martial law."[41]

That the fundamental difference between the two doctrines is one merely of argumentative technique is revealed by an examination of the treatment which courts have accorded to military measures undertaken by the Governor in suppressing domestic disturbances. The cases resolve themselves into two broad categories: (1) those involving military infractions of property interests, and (2) those concerned with invasions of interests of personality.

In the summer of 1934, violence arising out of the Minneapolis truck drivers' strike prompted the Governor of Minnesota to send troops into the City. His ensuing military order, restricting the movement of trucks to those operated by employers acquiescing in a strike settlement plan, was attacked by recalcitrant truck owners, who sought to enjoin the order as a deprivation of property without due process of law. Although asserting its authority to enjoin arbitrary and capricious acts of the Executive, the Federal District Court refused that remedy upon a finding that the facts of the situation justified the call to the troops and that the order could not be said to be unrelated to the necessities of the occasion or to fall outside the range of Executive discretion.[42]

Twenty years previously, during a desperate coal miners' strike in West Virginia, the Governor of that State ordered out the militia and suppressed an inflamatory Socialist newspaper which, he alleged, was thwarting his efforts to effect a compromise. In a suit for damages brought after the return of order, the West Virginia Supreme Court, which two years before had announced an extreme war-

37. Powers Mercantile Co. v. Olson, 7 F. Supp. 865 (D. Minn. 1934); Dakota Coal Co. v. Fraser, 883 Fed. 415 (D. N. D. 1919); In re McDonald, 49 Mont. 454, 143 Pac. 947 (1914); see Herlihy v. Donohue, 52 Mont. 601, 609, 161 Pac. 164, 166 (1916); cf. Hatfield v. Graham, 73 W. Va. 759, 81 S. E. 533 (1914).

38. In re Boyle, 6 Idaho, 609, 57 Pac. 706 (1899); State v. Brown, 71 W. Va. 519, 77 S. E. 243 (1912); Ex parte Jones, 71 W. Va. 567, 77 S. E. 1029 (1913).

But only so long as the executive does not exceed his constitutional power. In re Moyer, 35 Colo. 159, 85 Pac. 190 (1905); Drucker v. Salomon, 21 Wis. 621, 631 (1867); cf. Hawkins v. Governor, 1 Ark. 570 (1839) and the British cases cited *supra* note 25. See Note (1933) 33 COL. L. REV. 152, 153.

39. Strutwear Knitting Co. v. Olson, No. 2909 Eq. (D. Minn. Feb. 5, 1936); Hearon v. Calus, 183 S. E. 13 (S. C. 1935).

40. Sterling v. Constantin, 287 U. S. 378 (1932); United States v. Adams, 26 F. (2d) 141 (D. Colo. 1927); Russell Petroleum v. Walker, 162 Okla. 216, 19 P. (2d) 582 (1933); and cases cited *supra* note 39.

41. Ex parte Lavinder, 88 W. Va. 713, 108 S. E. 428 (1921); cf. The King (O'Brien) v. Military Governor [1924] 1 Ir. Rep. 32.

42. Powers Mercantile Co. v. Olson, 7 F. Supp. 865 (D. Minn. 1934), noted in Vol. 3, No. 3 (1934) INT. JURID. ASS'N. BUL. 8.

time doctrine of "martial law," sustained the Executive's action, but upon the basis that he had reasonable grounds for his bona fide belief that the necessity therefor existed, and that he had acted within the limits of his constitutional powers.[43] While this West Virginia case is the only one concerning military invasions of property interests in a jurisdiction which purports to clothe its Executive with supreme war-time powers, the clear implication of the decision is that military measures not undertaken in good faith, and unsupported by necessity, would not escape the sanction of the law.[44] Upon these grounds, other courts, which reject the West Virginia theory of extreme war-time powers, have condemned military infractions of property rights. Thus, when the Governors of Texas and Oklahoma promulgated declarations that insurrections existed in their respective states and summoned forth the troops to enforce oil proration orders, their military measures were promptly enjoined as being unjustified by any exigency and as constituting deprivations of the oil operators' properties without due process of law.[45] In January, 1936, the Governor of Minnesota again sent troops into the City of Minneapolis, at the instance of its Mayor, to prevent the violence which threatened to arise from a strike at the plant of the Strutwear Knitting Company. As the most effective means of preventing riot, the troops proceeded to close the plant. But the same court which, in the truck drivers' strike two years previously, had denied the injunction sought by truck owners,[42] now enjoined the Governor and the troops from interfering with the right of the Company to the use of its property, on the ground that, by the closing of the plant, the Company was deprived of its property without due process of law. The limits of executive authority were thereby transgressed.[46]

Abatement of disorder often requires military action more drastic than encroachments upon rights of private property. Invasions of interests of personality resolve themselves into two categories: the first comprising the direct application of force to an individual; the second concerned with his summary arrest and detention by the military authorities. Action falling within the first class is presented to the courts, after the passing of the exigency, in civil actions for assault and battery or in criminal prosecutions of soldiers for murder. *Ela v. Smith*[47] was a tort action, arising in 1855, against the Mayor of Boston and two officers of the Massachusetts volunteer militia for an assault on the plaintiff. Apprehending a riot over the return to the South of a fugitive slave, the Mayor called out the troops to clear the streets while the fugitive was being marched to the wharf for deportation. The plaintiff, attempting to pass through a guarded street, was pushed back and knocked down by the soldiers. The

43. Hatfield v. Graham, 73 W. Va. 759, 81 S. E. 533 (1914).

44. Id. at 766, 767, 108 S. E. at 535, 536.

45. Constantin v. Smith, 57 F. (2d) 227 (E. D. Tex. 1932), aff'd, Sterling v. Constantin, 287 U. S. 378 (1932); Russell Petroleum Co. v. Walker, 162 Okla. 216, 19 P. (2d) 582 (1933). Similarly, the recent action of the Governor of South Carolina, in employing the militia to oust hostile State Highway Department Commissioners, was enjoined as depriving them of their offices without due process of law. Hearon v. Calus, 183 S. E. 13 (S. C. 1935).

46. Strutwear Knitting Co. v. Olson, No. 2909 Eq. (D. Minn. Feb. 5, 1936). See N. Y. Times, Feb. 7, 1936, at 1.

47. 71 Mass. 121 (1855).

Massachusetts Supreme Judicial Court, adhering to the doctrine that the troops were called out to aid the civil authority as "armed police" only,[48] announced that no liability could be incurred for acts reasonable and necessary for the clearing and guarding of the streets. However, if the force used towards the plaintiff was excessive and unreasonable, recovery could be had. Thereupon it sent the case back for trial. Upon the same theory the Michigan Court, in *Bishop v. Vandercook*,[49] held that the use of a log to ditch autos which refused to stop for military search, constituted a wanton disregard for human life, and sustained an award of substantial damages against the military officer who had directed that such a measure be taken.

In *Manley v. State*,[50] a member of the Texas National Guard, under orders to keep the public out of an inclosure "at all hazards," upon the occasion of President Taft's visit to Dallas in 1909, ran his bayonet through a man attempting to pass through the military cordon. The man died, and the soldier was promptly prosecuted for murder. The Texas Court of Criminal Appeals held that even a command to guard the inclosure "at all hazards" would not authorize a militiaman to kill, or otherwise to violate the law. A soldier could use only such means as were necessary to carry out this order without taking life or committing an assault.[51] Another prosecution for murder, *State v. Coit*,[52] was that of an Ohio National Guard Colonel for having ordered the militia to fire on a mob which threatened to break in the door of a court house in an attempt to lynch a Negro charged with rape. The Court, announcing that the military was subordinate to the civil authority, instructed the jury that it was the duty of the defendant to use only such force as was necessary and proper to protect the prisoner and the public property. He could not legally take human life in accomplishing those ends unless he had first ascertained, by such a prudent and reasonable exercise of his faculties as the circumstances permitted, that such action was necessary and proper. The jury were further instructed that if the only destruction of property which was threatened was the breaking in of the court house door, the order to fire "in case" the door were broken could not be justified or excused on the ground that the Colonel was endeavoring to protect the public property. He had no right to wait until the destruction had been completed, and then to fire on the crowd.[53]

These four cases were decided by courts which held the military in a position subordinate to the civil power. But *Commonwealth v. Shortall*[54] arose in a Court which exalts the military above the civil power during times of domestic disturbance, and which embraces the doctrine that, during their active service, the rights and obligations of militiamen are to be judged by the standards of actual war.[55] In 1902, during a strike in the anthracite coal regions of Pennsylvania, several houses occupied by non-union men had been dynamited. The

48. Id. at 140.
49. 228 Mich. 299, 200 N. W. 278 (1924).
50. 62 Tex. Crim. Rep. 392, 137 S. W. 1137 (1911).
51. Id. at 399, 137 S. W. at 1141.
52. 8 Ohio Dec. 62 (Com. Pl. 1897).
53. Id. at 64, 65.
54. 206 Pa. 165, 55 Atl. 952 (1903). See Roberts, *The Case of Private Wadsworth* (1903) 51 AM. L. REG. 63, 161.
55. 206 Pa. 165, 170-174, 55 Atl. 952, 954-956 (1903).

Governor sent troops into the district, and a guard was placed at a house which had been dynamited two nights before, and which was ocupied by a woman and four small children. Orders were given to shoot if any attempt to dynamite was made or if suspicious characters ventured close. Near midnight a sentry discovered a man approaching. Four times he called him to halt. The man, unheeding, opened the gate and turned into the yard of the house. The sentry shot, and killed. Upon a writ of habeas corpus directed to the sheriff who was holding the slayer for criminal prosecution, the Supreme Court of Pennsylvania ordered his discharge. It was found that the order to shoot was a precautionary measure, and that the sentry had reasonable cause to believe in the necessity for action under it.

Any real difference between the decision in *Commonwealth v. Shortall*, by a Court which subordinates the civil authority, and the cases which limit the power of the militia to that of civil police only, is difficult of perception. All the decisions seem to be governed by the same rules of law—the ordinary principles of tort and criminal liability. Nor does any distinction seem to be made on the ground that the actor was a soldier.[56] The premise upon which the cases appear to be based is that in times of national peace a militiaman has no more privilege to take human life than any other officer or citizen.[57] In general, this privilege may be exercised only as a defensive measure, where the actor has reasonable cause to believe that it is necessary in order to prevent death or serious bodily harm to himself or to those whom he is protecting.[58] In *Commonwealth v. Shortall* the soldier was guarding a house and its occupants from an anticipated dynamiting; in *State v. Coit* he was protecting a Negro from a lynch mob.

The converse of this principle is that there is no privilege to take human life where there is no threat of death or serious bodily harm.[58] Accordingly, it would appear doubtful whether the aggressive tactics of modern militias in attacking crowds of strikers is justifiable. Such aggressiveness cannot be condoned as a precautionary measure.[59] Furthermore, since strikers, unless provoked, seldom threaten death or serious bodily harm to persons, military aggressiveness with deadly weapons would not seem justifiable on that score.

56. The fact that one is a member of the military does not give him a license to do those things which a civilian cannot do. Allen v. Gardner, 182 N. C. 425, 528, 109 S. E. 260, 262 (1921). See Lord Chief Justice Tindal's charge to the Bristol Grand Jury, Jan. 2, 1832, in the note to Rex v. Pinney, 5 Car. & P. 254, at 261.

57. See Manley v. State, 62 Tex. Crim. Rep. 392, 400, 137 S. W. 1137, 1141 (1911); Rex v. Pinney, 5 Car. & P. 254, 270.

58. See Manley v. State, 62 Tex. Crim. Rep. 392, 400, 137 S. W. 1137, 1141 (1911); State v. Mills, 6 Penn. 497, 502, 69 Atl. 841, 843 (Del. 1908); BURDICK, TORTS (1913) 59 et seq.; HARPER, TORTS (1933) c. 4; Bohlen, *The Privilege to Protect Property* (1926) 35 YALE L. J. 525.

59. In this respect, the instruction in State v. Coit, 8 Ohio Dec. 62 (Com. Pl. 1897), made a fine distinction between shooting as a protective device, and otherwise. To wait until the destruction had been completed, and then to fire on the crowd, could not be said to constitute defensive conduct. See report of the two "fierce battles" between Ohio National Guardsmen and strikers, at the Electric Auto-Lite plant, Toledo. N. Y. TIMES, May 25, 1934, at 1.

In this respect, the second instruction in *State v. Coit* should have gone further than it did. Aside from the question of protecting the Negro, the threat of breaking in the court house door, of itself, could not warrant an order to fire. While reasonable measures may be taken for the protection of property, it can seldom be said that the taking of life constitutes one of them.[60] Nor is this less true where militias are employed to guard factories from the stones and bricks of menacing strikers. Since the objects of destruction are generally limited to windows and doors, the social desirability of preventing their loss must outweigh the right of a human being to his life, before orders to fire under such circumstances would be justifiable. But it would appear to be conceded that no interest which is merely one of property can be equal or superior to the interest which both individual and society have in life and limb.[61]

More common as a means of abating disorder than the direct application of force is the arrest without warrant and temporary detention by the military authorities of those suspected of inciting or participating in the violence. Military officers often believe that the confinement of such participants is essential for the successful suppression of the disturbances. During the great textile strike of 1934, for example, National Guardsmen, summoned by the Governor of Georgia, arrested approximately 200 pickets and interned them in a concentration camp until termination of the strike.[62]

The question of the legality of such arrests is raised, during the period of military activity, by writs of habeas corpus. Approaches to the problem have varied according to the theories of gubernatorial military power which the courts have adopted. Courts which view the use of troops as inaugurating war-time military government have sustained military arrests either upon the theory that the privilege of the writ of habeas corpus is suspended, or that the Executive has power to ignore it.[63] Other courts reject this view as contrary to constitutional principles,[64] but reach the same result upon the ground of

60. See State v. Mills, 6 Penn. 497, 69 Atl. 841 (Del. 1908); State v. Taylor, 143 Mo. 150, 44 S. W. 785 (1898).

61. See Bohlen, *supra* note 58, at 528. 62. N. Y. TIMES, Sept. 17 to 23, 1934.

63. In re Boyle, 6 Idaho, 609, 57 Pac. 706 (1899), State v. Swope, 38 N. M. 53, 28 P. (2d) 4 (1933); State v. Brown, 71 W. Va. 519, 77 S. E. 243 (1912); Ex parte Jones, 71 W. Va. 567, 77 S. E. 1029 (1913); cf. Cox v. McNutt, 12 F. Supp. 355 (S. D. Ind. 1935); In re Moyer, 35 Colo. 159, 85 Pac. 190 (1905); Fairman, *Law of Martial Rule* (1928) 22 AM. POL. SCI. REV. 591, 609. But see Ex parte Vallandigham, Fed. Cas. No. 16,816 at 874 (C. C. S. D. Ohio 1863).

64. U. S. CONST. Art. I, § 9, cl. 2. By the Constitutions of most states, the writ of habeas corpus can only be suspended where, in cases of rebellion or invasion, the public safety requires it. Some state constitutions provide that it can never be suspended in any case. STIMSON, op. cit. *supra* note 1, §§ 126, 127. It is now generally conceded that the writ can be suspended only by the legislature, and not by the executive. See Ex parte Bollman and Swartout, 8 U. S. 75, 101 (1807); Ex parte Merryman, Fed. Cas. No. 9,487 at 144 (C. C. D. Md. 1861), McCall v. McDowell, Fed. Cas. No. 8,673 at 1235 (C. C. D. Calif. 1867); In re Gillis, 49 Mont. 454, 466, 143 Pac. 947, 951 (1914); Ex parte Moore, 64 N. C. 802, 808 (1870); In re Kemp, 16 Wis. 359, 380 (1863); see Brief of David Dudley Field in Ex parte Milligan, 71 U. S. 2, 40, 41 (1866). Fairman, *supra* note 63, at 608. But see Ex parte Field, Fed. Cas. No. 4,761 at 1 (C. C. D. Vt. 1862).

necessity.[65] In *Re Moyer*[65] and *Re McDonald*[65] the returns to the writs were similar. Each stated that the prisoner was a leader of the insurrection—a strike—that his arrest was necessary for its successful suppression, and that he would be released from military arrest as soon as that safely could be done. Upon such a showing the internments were sustained as reasonable measures within the discretion of the Executive and the military authorities under him, and as having direct relation to the suppression of the disturbance which the militia had been summoned to subdue.[66]

On the other hand, in *United States v. Adams.*[67] the Court, upon a finding that the strike disturbance was effectively handled by the civil authorities, held that there was no justification for a summary military arrest, and discharged the prisoner. Likewise, in *Ex parte Lavinder,*[68] the West Virginia Court, prime exponent of military supremacy in times of domestic disorder,[69] held that, since there was no actual warfare or military occupation, there was no "martial law," notwithstanding the Governor's proclamation to the contrary. Accordingly, those who had been detained under military arrest were discharged. As in the *Adams Case,* the disturbance was being handled by the civil authorities. This West Virginia decision would seem to indicate that any distinction between those cases based upon findings of reasonable necessity, and those based upon war-time analogies is more apparent than real.

Where military arrests have been sustained, courts have been careful to

65. In re Moyer, 35 Colo. 159, 85 Pac. 190 (1905); In re McDonald, 49 Mont. 454, 143 Pac. 947 (1914); Druecker v. Salomon, 21 Wis. 621 (1867); cf. the cases cited *supra* note 63. The actual holdings in all of them, except State v. Brown, would seem to rest solely upon necessity.

See Ex parte Moore, 64 N. C. 802 (1870) where the Court said, at 807, that the arrest and detention of the prisoner must be not only necessary, but *proper,* and held that it was not proper, for it violated the Declaration of Rights.

66. Cf. State v. Swope, 38 N. M. 53, 28 P. (2d) 4 (1933) and Ex parte Jones, 71 W. Va. 567, 77 S. E. 1029 (1913), cited *supra* note 63.

In answer to contentions that such military arrests and confinements constitute restraints of liberty without due process of law, courts adhering to both theories have pointed out that the prisoner is neither tried by military court nor denied the right of trial by jury nor punished for violation of the law. Thus, his detention, being merely to prevent the prisoner's taking part in the condition which the Governor is employing the militia to suppress, is said to violate none of his constitutional rights. In re Moyer, 35 Colo. 159, 167, 85 Pac. 190, 193 (1905); Ex parte Jones, 71 W. Va. 567, 608, 77 S. E. 1029, 1046 (1913).

The speciousness of this argument would seem to be apparent. That the prisoner is neither tried by military court nor denied the right of jury trial nor punished for crime cannot have any possible bearing upon the question whether the restraint upon his liberty is with or without due process of law. Nor can the purpose of the arrest change the character of the restraint. The only relevant consideration in determining whether a deprivation of liberty is or is not in accordance with due process would seem to be whether it had been or could have been achieved through the normal channels of the law,—by judicial process. Before a summary arrest and confinement can be justified upon the ground of necessity, resort to ordinary legal procedure must have become impossible. See, generally, Hall, *Arrest Without a Warrant* (1936) 49 HARV. L. REV. 566.

67. 26 F. (2d) 141 (D. Colo. 1927). 68. 88 W. Va. 713, 108 S. E. 428 (1921).

69. See State v. Brown, 71 W. Va. 519, 77 S. E. 243 (1912) and Ex parte Jones, 71 W. Va. 567, 77 S. E. 1029 (1913).

indicate that they are merely precautionary measures for the prevention of the exercise of a power hostile to the efforts of the Executive to restore order.[70] They cannot continue beyond the period of the emergency. Upon its termination the prisoner must either be set at liberty or turned over to the civil authorities for trial according to law.[71] Thus, the Court, in *Re McDonald,* while refusing to discharge a military prisoner where the disturbance was still in progress, granted him leave to re-apply for a writ of habeas corpus in case his confinement should be continued beyond the period of exigency.

Nevertheless, attempts have been made by military authorities to go beyond mere temporary detention and to punish their prisoners by sentences imposed by military commissions.[72] While the West Virginia case of *State v. Brown*[73] is universally cited as supporting such action, the actual holding of that case, if obfuscating dicta may be brushed aside, was that, the territory being still under military domination, the imprisonment ordered by the military commission was lawful. The question whether the re-establishment of order would terminate it was left open.[74] Two cases in federal district courts, however, have sustained in their entirety sentences imposed by such bodies.[75]

These two decisions can neither be reconciled with any other cases dealing with the power of the military in domestic disturbances, nor can they be justified upon any ground. Historically, military commissions are properly concomitants only of war, when civil government and civil courts within the embattled zone have been overthrown.[76] Their exercise of jurisdiction in times of domestic disturbance would appear to be unwarranted.[77] Convictions imposed

70. See Moyer v. Peabody, 212 U. S. 78, 84, 85 (1909); In re Moyer, 35 Colo. 159, 167, 168, 85 Pac. 190, 193 (1905); In re McDonald, 49 Mont. 454, 466, 143 Pac. 947, 951 (1914); cf. In re Boyle, 6 Idaho 609, 57 Pac. 706 (1899); State v. Swope, 38 N. M. 53, 28 Pa. (2d) 4 (1933), criticized in (1933) Vol. 2, No. 7 INT. JURID. ASS'N. BUL. 8; Ex parte Jones, 71 W. Va. 567, 77 S. E. 1029 (1913).

71. In re Gillis, 49 Mont. 454, 143 Pac. 947 (1914); Druecker v. Salomon, 21 Wis. 621 (1867); see In re Moyer, 35 Colo. 159, 85 Pac. 190 (1905).

72. Ex parte Milligan, 71 U. S. 2 (1866); In re Gillis, 49 Mont. 454, 143 Pac. 947 (1914); see (1933) Vol. 2, No. 7 INT. JURID. ASS'N. BUL. 8. During the Georgia textile strike, the military prisoners were "officially" awaiting trial by "court martial." They were, however, released upon termination of the strike. N. Y. TIMES, Sept. 19, 1934, at 3.

73. 71 W. Va. 519, 77 S. E. 243 (1912).

74. Id. at 527, 77 S. E. at 247: "We are not called upon to say whether the end of the reign of martial law in the territory in question will terminate the sentences and upon that question we express no opinion."

75. United States v. Wolters, 268 Fed. 69 (S. D. Tex. 1920), overruled, Constantin v. Smith, 57 F. (2d) 227, 241 (E. D. Tex. 1932); United States v. Fischer, 280 Fed. 203 (D. Neb. 1922). Both these cases are noted in (1935) 13 NEB. L. BUL. 292, 301. And see Note (1921) 5 MINN. L. REV. 540.

76. DAVIS, MILITARY LAW (3d ed. 1913) 307 et seq. They were initiated in 1847, during the war-time occupation of Mexico by the United States forces, and were extensively resorted to in Confederate territory during the Civil War. See 2 WINTHROP, MILITARY LAW (1886) 57 et seq.

77. Neither Davis nor Winthrop, op. cit. *supra* note 76, cites any cases sustaining their jurisdiction within domestic territory acknowledging allegiance to the United States. Note their use of the word "domestic" in referring to Confederate territory. But see *supra* note 32.

by such bodies cannot be said to be so related to the suppression of disorder that they could be sustained as precautionary measures upon the ground of military necessity.[78] The power of punishment can be exercised alone by the judiciary, through the means which the laws have provided for that purpose.[79] Military commissions constitute no part of the judicial system, and are governed by no definite code.[80] Convictions of civilians within the United States in times of national peace by such extra-judicial bodies, without trial by jury, would appear to contravene the guarantees of both Federal and State Constitutions.[81] Accordingly, the weight of authority holds sentences imposed by military commissions void, insofar as their purpose is punitive.[82] Their legitimate function during periods of domestic disturbance would seem to be limited to inquiry into the necessity for temporary confinement of persons apprehended by the military authorities as participants in the violence.[83]

III

Termination of the disturbance which the militia has been summoned to subdue brings with it civil actions for damages against both the Governor[84] and

78. See Underhill, *Jurisdiction of Military Tribunals* (1924) 12 CALIF. L. REV. 159, 178; Comment (1935) 13 NEB. L. BUL. 292, 301; cf. In re Gillis, 49 Mont. 454, 476, 143 Pac. 947, 954 (1914).

79. See Ex parte Milligan, 71 U. S. 2, 119, 123 (1866).

80. See In re Egan, Fed. Cas. No. 4,303 at 367 (C. C. N. D. N. Y. 1866); Rex v. Allen [1921] 2 Ir. Rep. 241; FAIRMAN, LAW OF MARTIAL RULE (1930) 197; Arnold, loc. cit. *supra* note 12. Military commissions are not bound by common law rules or procedure. See Rex (Garde) v. Strickland [1921] 2 Ir. Rep. 317. Nor has statute law defined their authority or made provision as to their constitution, composition, or procedure. DAVIS, MILITARY LAW (3d ed. 1913) 309.

81. U. S. CONST. Am. VI. Most state Constitutions provide that no person can be deprived of life, liberty, or property except by due process of law, or by the law of the land or the judgment of his peers, and that all persons accused shall have a speedy public trial by an impartial jury. STIMSON, op. cit. *supra* note 1, §§ 130, 131. Twenty-seven state Constitutions preserve the right to trial by jury inviolate. Id. at § 72. See Ex parte Milligan, 71 U. S. 2 (1886); Ex parte Merryman, Fed. Cas. No. 9,487 at 144 (C. C. D. Md. 1861); Curran, *Military Jurisdiction Over Civilians* (1933) 9 NOTRE DAME LAWYER 26.

82. Ex parte Milligan, 71 U. S. 2 (1886); Milligan v. Hovey, Fed. Cas. No. 9,605 at 380 (C. C. D. Ind. 1871); In re Egan, Fed. Cas. No. 4,303 at 367 (C. C. N. D. N. Y. 1866); In re Gillis, 49 Mont. 454, 143 Pac. 947 (1914). And see cases cited *supra* note 16; Fairman, *supra* note 9, at 23. The sentences of military commissions have been sustained however, without the boundaries of the United States. In re Kalanianaole, 10 Hawaii 29 (1895); England: Rex v. Allen [1921] 2 Ir. Rep. 241; Rex (Garde) v. Strickland [1921] 2 Ir. Rep. 317.

83. See Note (1913) 45 L. R. A. (N. S.) 996, 998.

84. Moyer v. Peabody, 212 U. S. 78 (1908) (Recovery denied); Hatfield v. Graham, 73 W. Va. 759, 81 S. E. 533 (1914) (same); Druecker v. Salomon, 21 Wis. 621 (1867) (same); Mostyn v. Fabrigas, 1 Cowp. 161 (1774). On Feb. 24, 1936, the Strutwear Knitting Company filed a suit for $101,000 damages against the Governor and the Adjutant-General of Minnesota and the Mayor of Minneapolis, as the result of the closing of its plant by the militia. N. Y. Times, Feb. 25, 1936, at 5. See FREUND, ADMINISTRATIVE POWERS OVER PERSONS AND PROPERTY (1928) 253.

the military officers under him,[85] and criminal prosecutions of soldiers for lives destroyed.[86] As has been indicated, neither the Governor nor the military derive any immunity from liability for their acts, whether by virtue of their military capacity, or by their power to suppress insurrection.[87] Nor do military orders, *per se*, even though they may appear reasonable, protect a subordinate from civil or criminal liability.[88] For wrongful acts, the militiaman is responsible, whether with or without orders.

Realizing the plight of the soldier, who is "liable to be shot by court-martial for disobedience of orders, or to be hanged by a judge and jury if he obeys,"[89] some states have sought by statute to relieve members of the militia from civil and criminal liability for acts done in the performance of their duty in active service.[90] Such an enactment, however, has been construed so as not to exempt

85. State v. District Court in and for Shelby County, 260 N. W. 73 (Iowa 1935); Franks v. Smith, 142 Ky. 232, 134 S. W. 484 (1911) (recovery allowed); O'Shee v. Stafford, 122 La. 444, 47 So. 764 (1908) (recovery allowed); Bishop v. Vandercook, 228 Mich. 299, 200 N. W. 278 (1924) (recovery allowed); Herlihy v. Donohue, 52 Mont. 601, 161 Pac. 164 (1916) (recovery allowed); Allen v. Gardner, 182 N. C. 425, 109 S. E. 260 (1921) (recovery allowed); cf. Mitchell v. Harmony, 54 U. S. 115 (1851); McCall v. McDowell, Fed. Cas. No. 8,673 at 1235 (C. C. D. Calif. 1867); Milligan v. Hovey, Fed. Cas. No. 9,605 at 380 (C. C. D. Ind. 1871); Johnson v. Jones, 44 Ill. 142 (1867); Griffin v. Wilcox, 21 Ind. 370 (1863); McLaughlin v. Green, 50 Miss. 453 (1874); Bryan v. Walker, 64 N. C. 141 (1870); Smith v. Shaw, 12 Johns. 257 (N. Y. 1815); McConnell v. Hampton, 12 Johns. 234 (N. Y. 1815); Jones v. Seward, 40 Barb. 563 (N. Y. 1863); Wright v. Fitzgerald, 27 State Trials 759 (1799).

86. Trial of Joseph Wall, 28 State Trials, 51 (1802).

87. See State v. Coit, 8 Ohio Dec. 62 (Com. Pl. 1897); DICEY, LAW OF THE CONSTITUTION (1915) 285.

88. Franks v. Smith, 142 Ky. 232, 134 S. W. 484 (1911); Bishop v. Vandercook, 228 Mich. 299, 200 N. W. 278 (1924); Allen v. Gardner, 182 N. C. 425, 109 S. E. 260 (1921); cf. Ex parte Field, Fed. Cas. No. 4,761 at 1 (C. C. D. Vt. 1862); Griffin v. Wilcox, 21 Ind. 370 (1863); Johnson v. Jones, 44 Ill. 142 (1867); McLaughlin v. Green, 50 Miss. 453 (1874); Bryan v. Walker, 64 N. C. 141 (1870). The British view is similar. See Rex (Ronayne) v. Strickland [1921] 2 IR. REP. 333, 334; DICEY, LAW OF THE CONSTITUTION (1915) 299. But see McCall v. McDowell, Fed. Cas. No. 8,673 at 1235 (C. C. D. Calif. 1867); Herlihy v. Donohue, 52 Mont. 601, 161 Pac. 164 (1916).

The orders a soldier is justified in executing are confined to such as a peace officer might execute. Franks v. Smith, *supra;* Bishop v. Vandercook, *supra.*

Where, however, the Governor or superior officer is immune from liability for orders given, his subordinates share the same immunity. See State v. District Court in and for Shelby County, 260 N. W. 73, 84 (Iowa 1935); Ela v. Smith, 71 Mass. 121, 136 (1855); Appeal of Hartranft, 85 Pa. 433, 444 (1877); Hatfield v. Graham, 73 W. Va. 759, 773, 81 S. E. 533, 538 (1914).

See, generally, Brown, *Military Orders as Civil Defense* (1917) 8 JOUR. CRIM. LAW 190; Roberts, loc. cit. *supra* note 54.

89. DICEY, LAW OF THE CONSTITUTION (1915) 299. See I STEPHEN, op. cit. *supra* note 12, at 204, 206.

90. See, e.g., MASS. ANN. LAWS (Lawyer's Co-op., 1933) c. 33, § 31; NEB. COMP. STAT. (1929) c. 55, § 150; N. Y. MIL. LAW (1921) § 15. The Louisiana statute (Act No. 181, 1904) was repealed in 1912 by Act No. 191. Cf. ILL. REV. STAT. ANN. (Smith-Hurd, 1934) c. 129, § 197; MICH. COMP. LAWS (1929) § 671.

a soldier from civil responsibility for his torts.[91] Any other construction, it was indicated, would have violated the state constitutional provision guaranteeing to every person adequate remedy by due process of law for injury done him.[92] This decision would appear to be sound upon a broader basis. While it may be fitting and proper to protect militiamen in the performance of their duty, complete immunity would operate in many cases to induce in military officers a lack of caution which would defeat the very objects for which the troops are called out. Nor is there any valid reason why soldiers should be clothed with an immunity which only attached to superior judges at common law.

IV

Judicial redress, however, pursued against the Governor and members of the militia can scarcely even palliate the broader social effects of gubernatorial resort to military action. "Martial law" has been most frequently associated with industrial conflicts.[93] The militia, summoned to suppress the violence attendant upon a strike, has, in general, suppressed the strike itself.[94] Executive military action is coming to replace the injunction as the strike-breaking machine par excellence. Use of the latter has been curbed by the Norris-La Guardia Anti-Injunction Act[95] and the various state enactments modelled after it.[96] But the utilization of troops at executive command effectively abrogates the provisions of these statutes. Yet there would appear to be no reason why the public policy they enunciate should not bind the executive as well as the judicial department of government. The social policy adopted by Congress and those state legislatures which have followed its lead would seem to militate against such a use of the military power of the state as renders these legislative enactments ineffective.[97]

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91. O'Shee v. Stafford, 122 La. 444, 47 So. 764 (1908). The Michigan statute, *supra* note 90, that troops shall be privileged from legal prosecution "except by direct order of the Governor," was likewise held not to bar a tort recovery against a military commander. Bishop v. Vandercook, 228 Mich. 299, 200 N. W. 278 (1924).

92. LA. CONST. Art. I, § 6. Most state constitutions have such or similar provisions. STIMSON, op. cit. *supra* note 1, § 70. Cf. Bishop v. Vandercook, 228 Mich. 299, 306, 200 N. W. 278, 280 (1924).

93. See WALTER WILSON, THE MILITIA (1935).

94. See, e.g., how the Georgia National Guard, during the textile strike in that state, was employed to re-open the mills, after the Governor had declared that "the right to work must be protected." N. Y. Times, Sept. 17 to 23, 1934. Cf. the use of troops in the San Francisco General Strike and in the Pullman strike of 1894. N. Y. Times, July 17, 1934, at 1, 2, 3, 5. See *Breaking Strikes by Martial Law* (1935) Vol. 4, No. 5. INT. JURID. ASS'N. BUL. 1; WILSON, op. cit. *supra* note 93.

95. 47 STAT. 70 (1932), 29 U. S. C. A. § 101-115 (1934), noted in (1932) 30 MICH. L. REV. 1257.

96. See, e.g., Idaho Laws (1933) c. 215; LA. GEN. STAT. (Dart, 1935) §§ 4379.5 to 4379.17; MASS. ANN. LAWS (Lawyer's Co-op., 1935) c. 149, §§ 20 A to 24; MINN. STAT. (Mason, Supp. 1934) §§ 4260-1 to 4260-15; PA. STAT. (Purdon's compact ed. 1936) Tit. 43, §§ 202 to 205; WASH. REV. STAT. ANN. (Remington, 1935) §§ 7612-1 to 7612-15. But see Safeway Stores v. Retail Clerks' Union, Local No. 148, 51 P. (2d) 372 (Wash. 1935).

97. At least one state, by statute, has prohibited the calling of its national guard into

Yet any check upon the Executive's employment of the military in labor disputes would depend for its efficacy upon judicial review and control. And judicial history reveals that the courts are not more likely to be jealous of the rights of labor than the Executive.[98] In passing upon military conduct, however, in cases involving labor disputes, courts could well consider the declared public policy of preserving to a large section of society the right to maintain and raise its standards by means of the strike. Thus, where the summary military arrest and detention of strikers is presented for judicial review in habeas corpus proceedings, the social role of the prisoners in exercising a right protected by the legislature, as well as their personal loss by actual deprivation of bodily freedom, should be weighed against the military necessity which is alleged as the cause for the confinement. This factor, which has hitherto not been considered in cases arising out of military interference in labor disputes, is deserving of serious attention.

THE LIMITED PARTNERSHIP

NOT infrequently, a person desires to invest in a non-corporate enterprise.[1] In order that the return upon his investment be not limited by a fixed rate of interest, he may wish to share in the profits of the business.[2] To protect his investment and ensure the largest possible return, he may insist upon some participation in the conduct of the enterprise. And in addition, he may desire that his liability for the debts of the business be limited to the amount which he wishes to invest.

At one time, investment upon such conditions in a non-corporate enterprise was not possible because profit-sharing alone sufficed to render the investor liable as a general partner.[3] In order to provide a means through which the non-corporate profit-sharing investor might secure participation in the management of the business and a limited liability, New York in 1822 enacted a statute enabling the organization of a non-corporate enterprise similar to the partner-

service in the event of disturbances arising from "labor trouble, strike or lockout." NEV. COMP. LAWS (Hillyer, 1930) § 7140.

98. See FRANKFURTER AND GREENE, THE LABOR INJUNCTION (1930) c. IV; Brissenden, *The Labor Injunction* (1933) 48 POL. SCI. Q. 413; Note (1935) 45 YALE L. J. 372; *Norris-La Guardia Act Bankrupted* (1935) Vol. 4, No. 6 INT. JURID. ASS'N. BUL. 7; *The New York Anti-Injunction Law in the Courts* (1935) Vol. 4, No. 7 INT. JURID. ASS'N. BUL. 1; Note (1936) 36 COL. L. REV. 494.

1. This comment assumes without discussion the existence of certain types of businesses to which the non-corporate form of organization is the most suitable, as well as the desirability of encouraging investment in such enterprises by allowing the investor certain privileges which he may desire. On the latter point, cf. Steffen, *The Independent Contractor and the Good Life* (1935) 2 U. OF CHI. L. REV. 501.

2. An arrangement of this character is also satisfactory to the management, since they thereby avoid the fixed charges upon the capital invested.

3. This doctrine, enunciated in the English cases of Grace v. Smith (1775) 2 W. Bl. 998 and Waugh v. Carver (1793) 2 H. Bl. 235 (1793), had a wide following in this country. Rowland v. Long, 45 Md. 439 (1876); Hackett v. Stanley, 115 N. Y. 625, 22 N. E. 745

ship *"en commandite"* recognized by the French Commercial Code.[4] The New York statute entitled this form of business organization a "limited partnership";[5] and other states, following the example set by New York, thereafter enacted similar limited partnership statutes which have with little amendment remained in force in most of these jurisdictions.[6]

When these statutes were drafted, and the limited partnerships formed under their provisions first subjected to judicial scrutiny, the general idea prevailed that those who partook of the profits of an enterprise when it prospered should in a like manner share in its losses in the event of failure.[7] The limited partnership was accordingly regarded by the courts as providing a privilege specially granted by the legislature to the profit-sharing investor.[8] Therefore, any conditions attached to the allowance of that privilege had to be meticulously met if the freedom from unlimited liability which it afforded, was to be secured.[9] In

(1889); MECHEM, PARTNERSHIP (2d ed. 1920) 77. See also Douglas, *Vicarious Liability and the Administration of Risk II* (1929) 38 YALE L. J. 720; Comment (1922) 22 COL. L. REV. 576.

4. See BATES, LIMITED PARTNERSHIP (1886) 17; 2 ROWLEY, THE MODERN LAW OF PARTNERSHIP (1916) 1376; Crane, *Unintended Partnership* (1924) 31 W. VA. L. Q. 1, 7. The historical background of the partnership *en commandite* and its introduction into New York, is treated in Ames v. Downing, 1 Bradf. 321 (N. Y. 1850); LEVI, MERCANTILE LAW (1854) 164, 215; POLLOCK, ESSAYS IN JURISPRUDENCE (1882) 100. For a discussion comparing the partnership *en commandite* of the French Code with the organization thus introduced into this country see TROUBAT, COMMANDATARY AND LIMITED PARTNERSHIPS IN THE UNITED STATES (1853).

5. "An Act Relative to Partnership," Laws of N. Y., 45th Sess., Ch. ccxliv. p. 259 (April 17, 1822). The adoption by New York of the limited partnership from the French Commercial Code is the first instance of the introduction of a statute into the United States, that was not of British origin. 3 KENT, COMM. *36.

6. BATES, *supra* note 4, at 21. Louisiana and Florida, since they originally were not English Colonies, always had some form of organization similar to the limited partnership. POLLOCK, *supra* note 4, at 101. At the present time, limited partnership statutes exist in all jurisdictions but Arizona and Florida, although the latter at one time did have such a statute. WARREN, CORPORATE ADVANTAGES WITHOUT INCORPORATION (1929) 306; Lewis, *The Uniform Limited Partnership Act* (1917) 65 U. OF PA. L. REV. 715, 716.

7. See Waugh v. Carver, 2 H. Bl. 235 (1793) at 247, "He who takes a moiety of the profits . . . shall be liable to losses . . . upon the principle that by taking a part of the profits, he takes from the creditors a part of that fund, which is the proper security to them for the payment of their debts." See also Lewis, *supra* note 6, at 720.

8. The limited partner was regarded as a general partner to whom a contingent limitation upon liability was allowed. In re Merrill, 17 Fed. Cas. No. 9,467, at 83 (C. C. N. D. N. Y. 1874); Pres. etc. of Manhattan Co. v. Laimbeer, 108 N. Y. 578, 581, 15 N. E. 712, 713 (1888) (criticizing above concept); Vanhorn v. Corcoran, 127 Pa. 255, 268, 18 Atl. 16, 19 (1889). See also Commissioner's Note to § 1 of the Uniform Limited Partnership Act (8 U. L. A.); BURDICK, PARTNERSHIP (3d ed. 1917) 385; Crane, *Are Limited Partnerships Necessary?* (1933) 17 MINN. L. REV. 351, 355.

9. See Holliday v. Union Bag and Paper Co., 3 Colo. 342, 344 (1877); Pierce v. Bryant, 87 Mass. 91, 94 (1862); Maloney v. Bruce, 94 Pa. 249, 252 (1880); cf. Clapp v. Lacey, 35 Conn. 463, 466 (1868); Van Riper v. Poppenhausen, 43 N. Y. 68, 73 (1870). At a later date, some courts, notably those in New York, adopted a more liberal view and held "substantial compliance" sufficient. They, moreover, limited the occasions for im-

addition, the fact that the limited partnership was not of common law origin further prompted some courts, on the ground that statutes in "derogation of the Common Law must be strictly construed" to require rigid adherence to their provisions.[10]

These statutes generally provide that a limited partnership can be formed by one or more general partners and "one or more persons who shall contribute in *actual cash* a specific sum as capital to the common stock, who shall be called a special (limited) partner."[11] In accordance with the customary strict construction, a contribution in the form of goods or other property has been held not to constitute a "cash" contribution, and the would-be limited partner, as a result, held liable as a general partner.[12] A further condition of obtaining limited liability under these statutes is that the persons desiring to form the limited partnership file and publish a certificate setting forth enumerated matters of detail.[13] It has been held that this condition is not fulfilled, and therefore a limited partnership not formed, when the certificate contains any false statement even though it be minor and unintentional;[14] when the requirements for publi-

position of partnership liability because of departures from statutory provisions, to those cases wherein such a result was expressly required by statute. See Fifth Ave. Bank v. Colgate, 120 N. Y. 381, 396, 24 N. E. 799, 803 (1890); White v. Eiseman, 134 N. Y. 101, 103, 31 N. E. 276, 277 (1892); Chick v. Robinson, 95 Fed. 619 (C. C. A. 6th, 1899).

10. See In re Merrill, 17 Fed. Cas. No. 9, 467 at 83 (C. C. N. D. N. Y. 1874). In Jacquin v. Buisson, 11 How. Prac. 385 (N. Y. 1855) at 393, the Common Law is called the "strong enemy of the limited partnership." See also Comment (1923) 36 HARV. L. REV. 1016.

11. E.g. D. C. CODE (1929) tit. 23 § 6; GA. CODE (1933) Tit. 75 § 402. Other statutes allow the contribution to be in property as well. E.g. COLO. ANN. STAT. (Mills, 1930) § 5358. If a contribution in property is allowed, the amount of the contribution consisting of property must be clearly stated and valued so as to avoid creation of impression that the contribution was wholly in cash. Holliday v. Union Bag and Paper Co., 3 Colo. 342 (1877); Vandike v. Rosskam, 67 Pa. 330 (1871); Maloney v. Bruce, 94 Pa. 249 (1880) (requirement of itemization and evaluation of specific articles of property). See also BATES, *supra* note 4, at 55 *et seq.*

12. McGinnis v. Farrelly, 27 Fed. 33 (C. C. S. D. N. Y. 1886) (check not cashed by time of filing of certificate not sufficient "cash" contribution); Pierce v. Bryant, 87 Mass. 91 (1862) (promissory notes); Haggerty v. Foster, 103 Mass. 17 (1869) (United States Government bearer bonds); Myers v. Edison General Electric Co., 59 N. J. Law 153, 35 Atl. 1069 (1896) (post-dated check); Durant v. Abendroth, 69 N. Y. 148 (1877) (post-dated check). But cf. White v. Eiseman, 134 N. Y. 101, 31 N. E. 276 (1894). Generally, the means by which the sums contributed were obtained, were held immaterial. In re Rasmussen, 287 Fed. 860 (C. C. A. 2d, 1923); Webster v. Lanum, 137 Fed. 376 (C. C. A. 2d, 1905); see Crehan v. Megargel, 234 N. Y. 67, 78, 136 N. E. 296, 299 (1922). But cf. Buckley v. Bramhall, 24 How. Prac. 455 (N. Y. 1863).

13. E.g. MONT. REV. CODE ANN. (Choate, 1921) §§ 8027, 8028, 8029, 8030, 8031, 8032. The requirements concerning the nature of the certificate were very strictly construed and generally in favor of the third party creditor. See Holliday v. Union Bag and Paper Co., 3 Colo. 342, 345 (1877); Haddock v. Grinnell Mfg. Co., 109 Pa. 372, 381, 1 Atl. 174, 176 (1885). See also BATES, *supra* note 4, at 56.

14. Lineweaver v. Slagle, 64 Md. 465, 2 Atl. 693 (1886); Van Ingen v. Whitman, 62 N. Y. 513 (1875); Spencer Optical Mfg. Co. v. Johnson, 53 S. C. 533, 31 S. E. 392 (1898). See also cases cited note 12 *supra*. The following excerpt from Durant v. Abendroth, 69

cation are not satisfied;[15] and when there has been a failure properly to renew the certificate upon its expiration.[16]

The limited partner under these statutes is expressly allowed to share in the profits of the business.[17] But if the sums paid the limited partner later appear to have been a withdrawal of his contribution, although at the time of payment they seemed to constitute permissible compensation, it has been held that the limited partner is liable to creditors at least for the amount so "withdrawn."[18] Similarly, the statutes expressly permit participation by the limited partner in the conduct of the business, to the extent of inspection of the partnership books and consultation with the general partners. However, usually by the same section of the statute, the transaction of any partnership business by the limited partner is forbidden, and if he "interfere(s) contrary to these provisions," then he "will be deemed a general partner."[19] The construction of such pro-

N. Y. 148 (1877) at 154 is typical: "The parties made a careless, though no doubt innocent mistake; but they failed to comply with the statute and the special (limited) partner is therefore deprived of its protection."

15. Smith v. Argall, 6 Hill, 479 (N. Y. 1844) aff'd 3 Denio 435 (N. Y. 1846); cf. Madison County Bank v. Gould, 5 Hill 309 (N. Y. 1843); Bowen v. Argall, 24 Wend. 496 (N. Y. 1840); Metropolitan National Bank v. Sirret, 97 N. Y. 320 (1884).

16. Statutes generally provide that at the expiration of the certificate, a renewal certificate must be filed, meeting certain requirements. See e.g. MONT. REV. CODE ANN. (Choate, 1921) § 8033. See Haddock v. Grinnell Mfg. Corp., 109 Pa. 372, 1 Atl. 174 (1895). (repetition of statements contained in original certificate insufficient when original capital has been impaired); Strang v. Thomas, 114 Wis. 599, 91 N. W. 237 (1902) (failure to certify and record renewal certificate made partnership general). But cf. Fifth Ave. Bank v. Colgate, 120 N. Y. 381, 24 N. E. 799 (1890).

Another typical provision, which has also often resulted in imposition of general partnership liability, is that any "alteration" in the names of the partners, or the nature of the business, or the capital thereof will result in the "dissolution of the limited partnership," unless a renewal certificate is filed. See e.g. N. C. CODE ANN. (Michie, 1935) § 3268; Beers v. Reynolds, 11 N. Y. 97 (1854); Andrews v. Schott, 10 Pa. 47 (1848) (change of membership); cf. Singer v. Kelly, 44 Pa. 145 (1863) (limited partner not held liable because of "alterations" effected by general partners, of which he was ignorant and in no way responsible).

17. E.g. OHIO GEN. CODE (Page, 1931) § 8048.

18. See, e.g., OHIO GEN. CODE (Page, 1931) § 8049: "If it appears that, by the payment of interest or profits to a special (limited) partner, the original capital has been reduced, the partner receiving it shall be bound to restore the amount." Cf. N. H. PUB. LAWS (1925) Ch. 156 § 7, imposing general partnership liability for withdrawals of capital. On what will constitute a withdrawal, see BATES, *supra* note 4 at 103; BURDICK, *supra* note 8, at 406. Intentional withdrawals will result in general partnership liability. Madison County Bank v. Gould, 5 Hill 309 (N. Y. 1843).

Although the limited partner may obtain the return of his contribution on the dissolution of the organization the return may be held a "withdrawal" if all creditors are not paid, even though at the time of such return, the assets were sufficient to meet all claims. Baily v. Hornthal, 154 N. Y. 648, 49 N. E. 56 (1898); Kittredge v. Langley, 252 N. Y. 405, 169 N. E. 626 (1930) noted in (1930) 43 HARV. L. REV. 1162; (1930) 4 ST. JOHNS L. REV. 300.

19. See, e.g., KANSAS REV. STAT. ANN. (1923) § 56-116. On the permissible degree of consultation and advice, see Ulman & Co. v. Briggs Payne & Co., 32 La. Ann. 655 (1880).

visions has generally been that "interference" will result from an attempt to participate further than by the exercise of the privileges specifically authorized in the statute.[20]

The fact that any minor infractions of or derivations from the statutory provisions would either prevent a limited partnership from being formed, or subject the "limited" partner to unlimited liability, despite proper formation of the limited partnership, naturally rendered the limited partnership a hazardous means of obtaining limited liability and therefor discouraged its employment. Thus interpreted, it was apparent that the statutes would have to be changed if the limited partnership was to be made an attractive form of non-corporate business organization.[21]

Accordingly, in 1916, a Uniform Limited Partnership Act was drafted to remedy the defects of the limited partnership as then recognized, and thereby to establish it as a non-corporate business organization through which a profit-sharing investor could safely obtain a limited liability and some participation in the conduct of the business.[22] In accordance with that purpose, the limited

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The limited partner could generally direct the conduct of the business when the general partners were incapacitated. Cropper & Co. v. Illinois Sewing Machine Co., 100 Miss. 127, 54 So. 849 (1911). The latter privilege is expressly granted in some statutes. See e.g., GA. CODE (1933) tit. 75, § 414. On the extent of the privilege to inspect books, see Sanderson v. Cooke, 256 N. Y. 73, 175 N. E. 518 (1931).

20. Farnsworth v. Boardman, 131 Mass. 115 (1881) (causing transfer of firms assets to third party); Madison County Bank v. Gould, 5 Hill 309 (N. Y. 1843) (negotiation of purchases); First National Bank of Canandaigua v. Whitney, 4 Lans. 34 (N. Y. 1871) (having caused transfer of all of firm assets to himself, limited partner was held liable even for those obligations arising before transfer); Richardson v. Hogg, 38 Pa. 153 (1861) (placing agent in firm as bookkeeper with general powers of supervision); Strang v. Thomas, 114 Wis. 599, 91 N. W. 237 (1902) (firm managed largely by board of directors chosen by limited partners). Bowes & Hall v. Holland (1857) 14 U. C. Q. B. 316; Hutchison v. Bowes (1858) 15 U. C. Q. B. 156 (limited partners met as managing board); cf. Continental Bank v. Strauss, 137 N. Y. 148, 32 N. E. 1066 (1893) (bringing of action for dissolution held not "interference"); Lawson v. Wilmer, 3 Phila. 122 (Pa. 1858) (taking possession of firm property after dissolution, held not "interference").

The limited partner could act with respect to the partnership as any third party, and not "interfere". In re Terry, 5 Bliss (U. S.) 110 (N. D. Ill. 1870); Ulman & Co. v. Briggs Payne & Co., 32 La. Ann. 655 (1880); Rayne & Co. v. Terrell, 33 La. Ann. 812 (1881); Metropolitan National Bank v. Sirret 97 N. Y. 320 (1884); Skolny v. Richter, 139 App. Div. 534, 124 N. Y. Supp. 152 (1st Dept., 1910) (limited partner may negotiate sales and purchases but not to the point of binding the firm); McKnight v. Ratcliff, 44 Pa. 156 (1863) (buy from and sell to firm).

21. See In re Marcuse & Co., 281 Fed. 928, 934 (C. C. A. 7th, 1922); Kittredge v. Langley, 252 N. Y. 405, 418, 169 N. E. 626, 630 (1930); Brown, *The Limited Partnership in Indiana* (1930) 5 IND. L. J. 421; Lewis, *supra* note 6, at 720; Comment (1923) 71 U. OF PA. L. REV. 150.

22. For a general discussion of the Uniform Act, its purposes and a comparison with pre-existing statutes, see Lewis, *The Uniform Limited Partnership Act* (1917) 65 U. OF PA. L. REV. 715. See also Commissioners' Note to § 1 of the Act (8 U. L. A.); Legis. (1922) 22 COL. L. REV. 669; WARREN, *supra* note 6, at 306; Comment (1923) 2 WIS L. REV. 301. The Act has been adopted in 20 jurisdictions. See HANDBOOK OF NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS (1934) 433. The manner in

partnership, which the Act regards as an unincorporated association composed of persons of limited and unlimited liability,[23] is brought into being if there be substantial compliance in good faith with the requirements for a certificate.[24] And if for any reason the limited partnership has not been legally formed, anyone who mistakenly but in good faith believed himself to have become a limited partner, may on discovering his error avoid general partnership liability by renouncing his interest in the profits of the business.[25] If, however, the limited partner knowingly makes false statements in the certificate, he is liable to creditors for the damage caused by reliance thereon.[26]

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which it is enacted in some jurisdictions is criticized by Perkins, *Uniformity in Uniform Legislation* (1920) 6 IOWA L. BULL. 1.

23. Although the Act calls the investor a "Limited Partner," he is "not in any sense a partner. He is, however, a member of the association." See Commissioners' Note to § 1 of the Act (8 U. L. A.); Lewis, *supra* note 22, at 724.

24. 8 U. L. A. § 2 (2). A very detailed certificate is, however, required by part 1 of § 2. For the occasions and procedure for amending and renewing the certificate, see §§ 24, 25.

The Act does not state the types of enterprise for which the limited partnership may be used, but leaves that to the discretion of the individual jurisdictions (§ 4). Although in some states, no business is specifically excluded [e.g. N. Y. PARTNERSHIP LAW (1922) § 92], the usual businesses excluded, if any, are banking, insurance and brokerage [e. g. ILL. REV. STAT. ANN. (Smith-Hurd, 1935) Ch. 106 1/2 § 46]. The wisdom of such exclusions may be questioned since the greatest utility of the limited partnership would be in financial businesses where there is the possibility of very great financial responsibility. See Brown, *supra* note 21, at 424.

25. 8 U. L. A. § 11. This section represents the introduction of a new concept into a limited partnership statute, since under pre-existing statutes, the good faith of the limited partner was generally held immaterial. See note 14, *supra*. The section has already received a liberal interpretation in Giles v. Vette, 263 U. S. 553 (1924) [aff'g 281 Fed. 928 (C. C. A. 7th, 1922) sub. Nom. In re Marcuse]. It has, however, not been decided whether compliance with the section requires paying back of all past profits and not merely the renunciation of the right to future profits. See Comment (1923) 36 HARV. L. REV. 1016; Comment (1924) 22 MICH. L. REV. 588; Comment (1923) 71 U. OF PA. L. REV. 150.

26. 8 U. L. A. § 6. Under the old statutes, a creditor could recover without showing injury. See Durant v. Abendroth, 69 N. Y. 148, 152 (1877).

Liability to creditors resulting from a violation of § 6 of the Act is one of three exceptions to the idea otherwise prevailing under the act, that the liability of a limited partner is always to the partnership and not to creditors. See Commissioners note to § 1. (8 U. L. A.). For enumeration of instances of liability to the partnership, see § 17. The second exception is in cases of a violation of § 7 by participation in control. See note 37, *infra*. The third arises when, contrary to the provisions of § 5, the limited partner permits his surname to be used in the partnership name. Then he is liable "as a general partner to partnership creditors who extend credit to the partnership without actual knowledge that he is not a general partner." Similar provisions forbidding the use of the limited partner's name or "& Co." are contained in other statutes. E.g. GA. CODE (1933) tit. 75 § 412. However, in the case of a violation of this provision, or of any other provision of these old statutes, the knowledge of the creditor as to the purported status of the "limited" partner was generally held immaterial. Andrews v. Schott, 10 Pa. 47 (1848); Pierce v. Bryant, 87 Mass. 91 (1862). But cf. Tracy v. Tuffly, 134 U. S. 206 (1890) commented upon in WARREN, *supra* note 6, at 308.

The Uniform Act clearly specifies the circumstances under which the limited partner may receive compensation and thus obviates the possibility that seemingly permissible compensation may at a later date be held a withdrawal of capital.[27] The problem of what constitutes a proper "cash" contribution, which arose under the other statutes, is avoided in the Uniform Act by a provision permitting the contribution to be in property as well as in cash.[28] Such contributions, however, may not be withdrawn except under circumstances which are clearly indicated.[29] Contrary to the practice current in jurisdictions where the old limited partnership statutes are still in force,[30] the limited partner recognized by the Uniform Act may claim as a creditor with respect to any advances or loans made by him to the firm.[31] The limited partner's interest is expressly made assignable[32] and provision is made for the effects of an assignment.[33] Accordingly, the death of the limited partner will no longer cause the

27. 8 U. L. A. § 15. Cf. note 18 *supra*.

28. 8 U. L. A. § 4. The term "property" is probably employed in its broadest significance, as signifying any set of legal relations capable of transfer or sale. However, the contribution expressly may not be in services.

29. 8 U. L. A. § 16. See Kittredge v. Langley, 252 N. Y. 405, 169 N. E. 626 (1930) cited note 18 *supra* (although the limited partnership was organized under the old New York Statute, the court interprets and construes the corresponding provisions of the Uniform Act).

30. White v. Hackett, 20 N. Y. 178 (1859); Mills v. Argall, 6 Paige 577 (N. Y. 1837); Dunnings Appeal, 44 Pa. 150 (1863); cf. Hayes v. Heyer, 35 N. Y. 326 (1866); Matter of Price, 171 N. Y. 15, 63 N. E. 526 (1902). *Contra:* Clapp v. Lacey, 35 Conn. 463 (1868).

31. 8 U. L. A. § 23(1)(a). With respect to his contribution, the limited partner may claim only after creditors have been satisfied but before any of the general partners. However, the degree of priority among the partners general and limited as set out in § 23 may be modified by an agreement *inter se*. Hays v. Wightman, 237 App. Div. 158, 261 N. Y. Supp. 275 (1st Dep't 1932), aff'd 261 N. Y. 708, 185 N. E. 802 (1933). See also § 12 which permits one person to be both a general and a limited partner, discussed in Lewis, *supra* note 22, at 725.

32. 8 U. L. A. § 19. Some of the older statutes also made the limited partner's interest assignable. E.g. IND. STAT. ANN. (Burns, 1926) § 12158.

The question arises whether the drafters of the Uniform Act should have made provision for a limited partnership, in which the interest of the limited partner is represented by shares that are freely transferable. A partnership *"en commandite"* of that type was recognized in the French Commercial Code in addition to the one adopted by New York. The Partnership with transferable shares was, however, deliberately excluded when the original New York statute was drafted. See Ames v. Downing, 1 Bradf. 321, 330 (N. Y. 1850). Perhaps, by not incorporating this second form of limited partnership, the drafters of the Uniform Act have narrowed the field of operation of the limited partnership. However, a recent case has demonstrated that it may be possible to create a limited partnership with transferable shares by putting the trustee of a business trust in the position of limited partner. Crehan v. Megargel, 234 N. Y. 67, 136 N. E. 296 (1922) discussed in WRIGHTINGTON, UNINCORPORATED ASSOCIATIONS AND BUSINESS TRUSTS (1923) 93, 96 and criticized in WARREN, *supra* note 6, at 311. See also Comment (1922) 22 COL. L. REV. 576; cf. Comment (1922) 8 CORN. L. Q. 90, 93.

33. 8 U. L. A. § 19. The assignee does not acquire all the rights and privileges of the limited partner, unless all the other members of the firm consent to his becoming a "substituted limited" partner, and the certificate is duly amended in accordance with the provisions of § 25.

dissolution of the firm.[34]

Unlike the other sections of the Uniform Act, those provisions dealing with the extent to which the limited partner may participate in the management of the partnership without incurring unlimited liability, are quite vague.[35] In Section 10, the Act enumerates the "rights" of the limited partner, namely, the right of access to the partnership books, full information concerning partnership affairs, and the right to dissolution and winding up by decree of court.[36] And in Section 7, it is provided that the limited partner "becomes liable as a general partner (when) in addition to the exercise of his rights and powers as a limited partner, he takes part in the *control* of the business."[37] But nowhere in the Act is the term "control" defined, and commentaries upon the Uniform Act cast no light upon its meaning.[38] Since Section 7 has not as yet been interpreted by any court, the significance of "control," as therein used, is uncertain.

Of course, under the express language of Section 7, it is evident that the limited partner may exercise those privileges which are specifically granted him by Section 10. It is at least arguable, however, that any privileges exercised in excess of those expressly authorized will result in participation in "control" within the meaning of Section 7,[39] just as the "interference" sections of the pre-existing statutes were generally interpreted to render the would-be limited partner liable as a general partner whenever he attempted to participate in the man-

34. The death of a limited partner has been held to cause the dissolution of a partnership formed under the old statutes. Ames v. Downing, 1 Bradf. 321 (1850); see Jacquin v. Buisson, 11 How. Prac. 385, 393 (N. Y. 1855). The rights of the executor of a deceased limited partner are given in § 21.

Under § 20 of the Uniform Act, the death, retirement or insanity of a general partner will, with certain exceptions, dissolve the partnership.

35. The Uniform Act represents a great improvement over pre-existing statutes in the definiteness and specificness of its provisions. See, e.g., § 18, expressly making the interest of the limited partner personal property; § 22, setting forth the rights of the creditors of a limited partner; § 26, providing who are proper parties to actions; § 28, indicating the rules of construction applicable to the Act and making inapplicable the rule that statutes in derogation of the common law are to be strictly construed. (See note 10, *supra.*)

36. 8 U. L. A. § 10. The section in part 2 provides that the limited partner is also to have the right to compensation by way of income as provided in § 15, and to the return of his contribution on dissolution as provided in § 16. See notes 27, 29 *supra.*

In § 9, the rights of the general partner in the limited partnership are expressed.

37. 8 U. L. A. § 7. The limited partner who violates the provisions of § 7 apparently may not avail himself of the privilege offered by § 11 (see note 25, *supra*). See also Commissioners' note to § 11 (8 U. L. A.).

The analogous provisions of the English Limited Partnership Act allow the limited partner the privilege of inspecting books and obtaining information, and provide that if the limited partner takes part in the management of the partnership he shall be liable for all debts and obligations of the firm incurred during that time. THE LIMITED PARTNERSHIP ACT (1907) 7 Edw. VII, c. 24, § 6 (1). See also LINDLEY, PARTNERSHIP (10th ed., 1935) 936; Burdick, *The Limited Partnership in England and America* (1908) 6 MICH. L. REV. 525.

38. E.g., Crane, *Are Limited Partnerships Necessary* (1933) 17 MINN. L. REV. 351; Lewis, *The Uniform Limited Partnership Act* (1917) 65 U. OF PA. L. REV. 715. See also Commissioners' Notes to §§ 1, 7 and 10 (8 U. L. A.).

39. Cf. Crane, *supra* note 38, at 363.

agement of the business in a degree greater than that expressly permitted.[39] This interpretation may be said to be applicable to the Uniform Act on the ground that the "interference" provisions have in substance been reënacted in the Uniform Act. Although in the other statutes, the enumeration of permissible privileges and the penalty for "interference" in management are generally found in the same section,[19] the separation of similar provisions in the Uniform Act does not seem important. The language of Section 7, namely, "in addition to the exercise of his rights and powers as a limited partner," incorporates by reference the provisions of Section 10. Nor is it material that Section 7 speaks of "liability as a general partner," whereas in the other statutes, the interfering limited partner is "deemed a general partner." This change in language may be said to be merely declaratory of those decisions which hold that when a "limited" partner has failed to obtain, or lost through interference, the limitation upon his liability, although he is then obligated as a general partner, he is not necessarily thereby transformed into a general partner for other purposes.[40]

On the other hand, however, the introduction of the term "control" as the basis for the imposition of general partnership liability upon the limited partner may be indicative of an intent to permit a different measure of participation than obtains under the "interference" provisions of the preëxisting statutes. The criterion of control has comparatively recently developed into one of the most important tests of partnership liability.[41] Since the drafting of the original limited partnership statutes, this standard has almost universally been employed to determine partnership liability—not only that of the profit-sharing investor,[42] but of the cestui of the business trust.[43] Hence, it may be main-

40. Robinson v. McIntosh, 3 E. D. Smith 221 (N. Y. 1854) (defective formation); Whittemore v. MacDonnell, 6 U. C. C. P. 547 (1857) (interference); Tilge v. Brooks, 124 Pa. 178, 16 Atl. 746 (1889); see Abendorth v. Van Dolsen, 131 U. S. 66, 73 (1889); cf. Hutchins v. Page, 204 Mass. 284, 90 N. E. 565 (1909) (defective formation, but limited partner held entitled in his suit against the general partners to share in the good will of the business on dissolution). But see Hogg v. Ellis, 8 How. Prac. 473, 474 (N. Y. 1853). See also BATES, *supra* note 4, at 89.

41. See Rowley, *The Influence of Control in the Determination of Partnership Liability* (1928) 26 MICH. L. REV. 290; Crane *supra* note 3, at 6; Douglas, *supra* note 3, at 721. This test has also been adopted by the Uniform Partnership Act. See Commissioners' Note to § 6 (7 U. L. A.)

42. See Steffen, *supra* note 1, at 516. For a rationalization of "control" as the power to manipulate the profit differential so as to effectuate distribution of risk, see Douglas, *supra* note 3, at 720 et seq. See also as representative cases, Nowell v. Oswald, 96 Cal. App. 536, 274 Pac. 423 (1929), noted (1929) 38 YALE L. J. 1152; Southern Can Co. v. Sayler, 152 Md. 303, 136 Atl. 624 (1927) (lender held general partner where he was given privilege of exclusive sale of product, power to determine payroll, and all goods manufactured were to be stored in his name and not moved without his consent); Martin v. Peyton, 246 N. Y. 213, 158 N. E. 77 (1927) (extensive veto power, no partnership); Austin Nichols & Co. v. Neil, 62 N. J. Law 462, 41 Atl. 834 (1898) (lease giving lessor right to be consulted in employment of servants, to place agent to keep accounts, to join in price fixing on certain items, held not partnership agreement).

43. See Magruder, *The Position of Shareholders in Business Trusts* (1923) 23 COL. L. REV. 423; WARREN, *supra* note 6, at 382; WRIGHTINGTON, *supra* note 32 at 60 et seq. Here, too, the question is whether the cestuis and not the trustees may be said to be in

tained that when the Act provides that the limited partner shall be liable as a general partner when he takes part in the "control" of the business, the "control" referred to constitutes the same standard as that used to determine partnership liability apart from the Act. And if such be the interpretation of Section 7, then the fact that the limited partner attempts to obtain a measure of participation in the conduct of the enterprise greater than that expressly authorized, need not necessarily subject him to unlimited liability.

It is evident that the Uniform Act represents a substantial improvement over the preëxisting statutes. Yet it is by no means clear that the limited partnership for which the Uniform Act provides, presents an opportunity for investment for which there is any need at the present time. To the investor who desires merely a share of the profits and a limited liability, the limited partnership today offers no advantages that are not otherwise obtainable. For it is now possible in almost every jurisdiction for an investor to obtain a share of the profits of an enterprise, and yet limit his liability to the amount which he wishes to invest.[44] And while as a limited partner, this investor would be assured of certain possibly advantageous restrictions upon the privileges of the entrepreneur or general partners, and of the right under certain circumstances to force the dissolution of the partnership and obtain an accounting, these alone, do not provide sufficient reason for becoming a limited partner.[45] For, these rights, if desired, generally may be obtained through contract or proper court action.

The profit-sharing investor who desires to participate in the management of the enterprise, but only through the exercise of the privileges of obtaining information and inspecting books, may find it advantageous to become a limited

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"control" of the enterprise. For a rationalization, see Douglas, *supra* note 3, at 740. See also Comment (1928) 37 YALE L. J. 1103, at 1108, for abstracts of leading cases on what constitutes "control."

44. The steps leading to the breakdown of the doctrine that profit-sharing conclusively results in partnership liability are described in Douglas, *supra* note 3, at 720, and in LINDLEY, *supra* note 37 at 52 et seq.; the cause, in Steffen, *supra* note 1, at 517. On the latter point see also Eastman v. Clark, 53 N. H. 276 (1872). In some states, notably New York, the profit-sharing doctrine was believed to be so firmly entrenched in the law of the jurisdiction that it could be changed only by legislative action. See Hackett v. Stanley, 115 N. Y. 625, 22 N. E. 745 (1889); Comment (1922) 22 COL. L. REV. 576; MECHEM, PARTNERSHIP (2d ed. 1920) 84. This change was effected in New York by the adoption of the Uniform Partnership Act: Laws 1919, ch. 408. However, the influence of profit-sharing as indicia of partnership has never disappeared. Even under the Uniform Partnership Act, it still is prima facie evidence of partnership. 7 U. L. A. § 7 (4).

45. See 8 U. L. A. § 9 (restrictions upon the rights of general partners in a limited partnership), and § 32 of the Uniform Partnership Act (7 U. L. A. § 32) which sets forth the occasions upon which a general partner may force a dissolution of the partnership. The latter section has apparently been incorporated into the Limited Partnership Act by § 10, which says, "The limited partner shall have the same rights as a general partner to . . . (3) have dissolution and winding up by decree of court."

The justification now urged for the limited partnership in view of the modification of the profit-sharing rule is that the limited partnership offers such degree of participation in the conduct of the enterprise, as would otherwise impose partnership liability on the profit-sharing investor. See Commissioner's note to § 1 (8 U. L. A.); Lewis, *supra* note 22, at 720.

partner for the reason that such privileges are expressly allowed him under the Uniform Act.[36] Indeed, commentators upon the Act have maintained that such an investor should always become a limited partner in order to avoid any possibility of unlimited liability.[46] For, an attempt to secure such privileges might be regarded by some courts as a contrivance to obtain the advantages of a limited partnership without complying with the limited partnership statutes, the investor consequently being held liable as a general partner.[47] However, usually the reservation of the right to information and to inspection of the firm's books is not now held sufficient to constitute the profit-sharing investor a partner in the enterprise.[48] But the general desirability of becoming a limited partner in such a case, both as a precautionary measure and to obtain the privileges assured him by the Act[45] must be conceded.[49]

In the more usual situation, however, of the investor who desires to participate further than by merely inspecting books and obtaining information, it is questionable whether the limited partnership for which the Uniform Act provides, affords the means of securing the greatest possible degree of participation consistent with a limited liability. Under a favorable interpretation of Section 7, the limited partner will be allowed to exercise the privileges specifically granted him plus those which have been held not to create partnership liability when reserved to one who has merely lent capital to the business. Hence, in any event the sum total of the permissible privilges of the limited partner will be equal only to that of the general investor.[48] And under the interpretation of Section 7 which would restrict the permissible acts of "control" to those speci-

46. See Crane, *supra* note 38, at 360.

47. There are some cases, generally those in which the validity of the business trust is attacked, where, although there is in reality no measure of participation reserved to the cestuis, the organization is held a partnership because of participation in "control." Here language may be found to the effect that where two or more persons associate together in carrying on an enterprise for mutual benefit, exemption from personal liability may be obtained only through compliance with the limited partnership or corporation statutes. See Wells v. Mackay Telegraph Cable Co., 239 S. W. 1001, 1006 (Tex. Civ. App. 1922); Thompson v. Schmitt, 274 S. W. 554, 560 (Tex. Sup. Ct. 1925) noted in (1925) 39 HARV. L. REV. 276. *Contra*: Betts v. Hackathorn, 159 Ark. 621, 252 S. W. 602 (1923). In effect, such holdings involve a return to the doctrine that profit-sharing conclusively establishes partnership liability. See Rowley, *supra* note 41, at 300; Hildebrand, *The Massachusetts Trust—a Sequel* (1925) 4 TEX. L. REV. 57.

48. Giles v. Vette, 263 U. S. 553 (1924); Petition of Williams, 297 Fed. 696 (C. C. A. 1st, 1924) cert. denied 265 U. S. 593 (1924); Martin v. Peyton, 246 N. Y. 213, 158 N. E. 77 (1927); Thillman v. Benton, 82 Md. 64, 33 Atl. 485 (1895); Cudahy Packing Co. v. Hibon, 92 Miss. 234, 46 So. 73, 18 L. R. A. (n.s.) 975 (1908); cf. Salter v. Condon, 236 Ill. App. 17 (1925). But cf. Spaulding v. Stubbings, 86 Wis. 255, 56 N. W. 469 (1893). See also Crane, *Unintended Partnership* (1924) 31 W. VA. L. Q. 1, 7.

49. However, the taxability of the partnership income is a factor to be considered. See New York statute (L. 1935 c. 33), taxing the net income of all unincorporated associations. Although under the Federal Income Tax Laws only the distributive share of each partner is taxed, the partnership is required to file a return of income received. See 48 STAT. 730, 26 U. S. C. A. § 181 (1934); U. S. Treas. Reg. 86, art. 181-1.

The share of the limited partner has been held taxable as income derived from a trade or business and not income received from interest on money loaned. Parker v. Commissioner of Corporations, 255 Mass. 546, 152 N. E. 34, 45 A. L. R. 1379 (1926).

fically authorized,[39] a limited partner could not, without incurring a partnership liability, exercise as much "control" over the affairs of the enterprise as would be permitted him as a general investor in that enterprise.

Moreover, although under the most liberal interpretation of Section 7, the tests as to that degree of participation which will result in the imposition of partnership liability upon the general investor and the limited partner may be alike *in vacuo,* the former may be able to acquire certain privileges which, if exercised by a limited partner, would probably be held to violate Section 7. Of course, the power to initiate and direct the execution of policy will result in the imposition of partnership liability upon either the limited partner or the profit-sharing investor.[50] But the courts have allowed the latter an extensive veto power, on the ground that it constitutes security for the investment.[51] In a contract of limited partnership, the reservation of any comprehensive privileges cannot so well be made to appear as security.[52] The investor is here

50. Strang v. Thomas, 114 Wis. 599, 91 N. W. 237 (1902) ("interference" case); Southern Can Co. v. Sayler, 152 Md. 303, 136 Atl. 624 (1927) discussed in Douglas, *supra* note 3, at 732. See also Rowley, *supra* note 41, at 301.

51. Martin v. Peyton, 246 N. Y. 213, 158 N. E. 77 (1922); Mollwo, March & Co. v. Court of Wards, L. R. 4 P. C. 419 (1872); Cassidy v. Hall, 97 N. Y. 159 (1884). From the point of view of the investor who desires to protect his investment and obtain the largest possible return by curbing speculative ventures, the broad veto power is the most effective. The fact that such a power is permissible only where it can be made to appear as "security" is illustrated by the opinion in Martin v. Peyton, *supra.*

52. Since "partnership" is not a fixed concept, but more often the means of expressing the result reached, namely unlimited liability, it is of importance that an attempt be made to keep the court from thinking in terms of "partnership" when the agreement is before it for construction. This may be accomplished if the contract between "investor" and entrepreneur suggests a relationship that will afford "protective coloration" for the degree of participation in the conduct of the enterprise. (Cf. Steffen, *supra* note 1, at 520). Such is the situation in the "lease" cases, [see, e.g., In re Owl Drug Co., 12 F. Supp. 439 (D. Nev. 1935); Holmes v. Old Colony Rr. Corp., 71 Mass. 58 (Mass. 1855); Hackney Co. v. Robert E. Lee Hotel, 156 Tenn. 243, 300 S. W. 1 (1927). But cf. Merrall v. Dobbins, 169 Pa. 480, 32 Atl. 578 (1895); Whitney v. Ludington, 17 Wis. 140 (1863)] and in those cases in which the creditors of an insolvent enterprise take over the management of the business, run it and yet are not held liable as partners even for debts incurred during that period. See, e. g., In re Hoyne, 277 Fed. 668 (C. C. A. 7th, 1922); Wells Stone Mercantile Co. v. Grover, 7 N. D. 460, 75 N. W. 911 (1898); Cox v. Hickman, 8 H. L. Cas. 268 (1860). But cf. Purvis v. Butler, 87 Mich. 248, 49 N. W. 564 (1891); Furnace Run Saw Mill & Lumber Co. v. Heller Bros., 84 Ohio St. 201, 95 N. E. 771 (1911). This group of cases is rationalized in Douglas, *supra* note 3, at 737.

When the reservation of a measure of participation in the management is sought to be justified on the basis of the "debtor-creditor" relationship, it may be necessary that the investment of the creditor not appear to be a continuing stake in the enterprise. Cf. Hackett v. Stanley, 115 N. Y. 625, 22 N. E. 745 (1889); Rosenfield v. Haight, 53 Wis. 260, 10 N. W. 378 (1881); San Joaquin Light and Power Corp. v. Costaloupes, 96 Cal. App. 322, 274 Pac. 84 (1929) [latter case, however, rendered before adoption in California of the Uniform Partnership Act, see In re Mission Dairy Co., 56 F. (2d) 346 (C. C. A. 9th, 1932)]. But cf. Waverly Bank v. Hall, 150 Pa. 466, 24 Atl. 665 (1892).

denominated a "partner", albeit a "limited" partner,[53] and even under the Uniform Act is by definition a co-owner of the business.[54]

STATUS OF HOLDERS OF HYBRID SECURITIES: STOCKHOLDERS OR CREDITORS?

As a general rule corporate securities are broadly divisible into stocks and bonds. The former normally provide for voting control, a permanent interest in the enterprise, and an investment return contingent upon the existence of net profits or surplus.[1] The latter, on the other hand do not give the holders any voice in the management and usually provide for payment of a definite principal amount on a certain date with specified interest in the meantime payable regularly and at all events.[2] However, many modern corporations, presumably to make investment in such companies more attractive,[3] have issued "hybrid" or "compromise" securities, purporting to combine in a single security some normal characteristics of both stocks and bonds.[4] Among such hybrid types are redeemable "stocks,"[5] which are a corporation's agreements to repurchase its own "stock" at a fixed time,[6] and participating operation certificates, wherein a

53. The possible effect of calling the investor a "limited partner" is demonstrated in the opinion of Evans, Circuit Judge, dissenting in In re Marcuse, 281 Fed. 928 (C. C. A. 7th, 1922) at 942, wherein he distinguishes an earlier case [In re Hoyne, 277 Fed. 668 (C. C. A. 7th, 1922)] partly on the ground that, in the latter, the parties had designated themselves as "debtor and creditor," whereas in the instant case, they were called partners, although "limited partners."

54. See 1 of the Uniform Limited Partnership Act (8 U. L. A. 1), defining the limited partnership as a "partnership . . ." and § 6 of the Uniform Partnership Act, defining a partnership as an association of two or more persons to carry on as co-owners a business for profit. See also Magruder, *Stockholder's Liability in Defective Corporations* (1927) 40 HARV. L. REV. 733, 736.

1. See DEWING, FINANCIAL POLICY OF CORPORATIONS (3d ed. 1934) 18, 63; 6 FLETCHER CORPORATIONS (1917) § 3630.

At common law and today by statute stockholders can be paid dividends only out of surplus or profits over and above the corporation's capital. See Benas v. Title Guaranty Trust Co., 267 S. W. 28, 29 (Mo. App. 1924).

2. See In re Fechheimer Fishel Co., 212 Fed. 357, 360 (C. C. A. 2d, 1914); DEWING, op. cit. *supra* note 1, at 69, 75; 2 JONES, BONDS (1935) § 601.

3. "In matters of investment there is much in a name!"—DEWING, op. cit. *supra* note 1, at 107.

4. See Jones, *Redeemable Corporate Securities* (1931) 5 So. CAL. L. REV. 83, at 97.

5. The post-war popularity of the compulsory redemption clause in non-voting preferred stock issues has waned in recent years. See BADGER, INVESTMENT PRINCIPLES AND PRACTICES (1928) 222; DEWING, op. cit. *supra* note 1, at 51. A possible reason for the trend away from this device may be found in the fact that the existence of an issue of such securities weakens a corporation's credit rating to some extent. See Jones, *supra* note 4, at 88, 89.

6. Redeemable "stocks" herein referred to are those with absolute rights of redemption and without voting rights. The majority of courts have held that the existence of net profits or surplus is an implied condition precedent to the fulfillment of the redemption

corporation promises to segregate a fixed portion of its gross income and to pay the certificate holders at somewhat indefinite intervals the money so set aside until they have received double the amount of their original investments.[7] Questions as to the status of holders of these securities have often arisen in bankruptcy proceedings, where they have sought to be treated on an equal footing with unsecured creditors. Usually they have been relegated in such cases to a position inferior to that of such creditors.[8] In the future the status of these two types of hybrids and, of more importance, others somewhat similar to them may arise not only in ordinary bankruptcies, but also in proceedings under 77B of the Bankruptcy Act,[9] where it is essential to decide whether the holders

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promise. Thus enforcement has been denied in bankruptcies. Keith v. Kilmer, 261 Fed. 733 (C. C. A. 1st, 1919), cert. denied, 252 U. S. 578 (1920); In re Hicks-Fuller Co., 9 F. (2d) 492 (C. C. A. 8th, 1925); Quinn-Marshall Co. v. McDaniels Co., 5 F. Supp. 937 (M. D. N. C. 1934). *Contra:* In re Fifty Gold Mines Corp., 190 Fed. 105 (D. Colo. 1911), rev'd Spencer v. Smith, 201 Fed. 647 (C. C. A. 8th, 1912); cf. Durand v. Brown, 236 Fed. 609 (C. C. A. 6th, 1916).

Under similar circumstances courts have reluctantly enforced such agreements where by statute the holders were placed on a par with creditors. Mannington v. Hocking Valley Ry. Co., 183 Fed. 133 (S. D. Ohio 1910); Heller v. National Marine Bank, 89 Md. 602, 43 Atl. 800 (1899); Williams v. Parker, 136 Mass. 204 (1884); Burt v. Rattle, 31 Ohio St. 116 (1876); cf. Cotting v. New York and New England Rr., 54 Conn. 156, 5 Atl. 851 (1886). But cf. Vanden Bosch v. Michigan Trust Co., 35 F. (2d) 643 (C. C. A. 6th, 1929), noted in (1930) 28 MICH. L. REV. 764.

7. Courts have held that holders of these securities have no rights as against general creditors. United States & Mexican Oil Co. v. Keystone Auto Gas & Oil Service Co., 19 F. (2d) 624 (W. D. Penn. 1924) (fund for certificate holders had accumulated in bank); Cities Service Refining Co. v. Go-Gas Co., unreported (D. Del.); In re Hawkeye Oil Co., 19 F. (2d) 151 (D. Del. 1927).

Other courts have had merely to pass on the question whether such contracts gave the holders an equitable lien either to money actually deposited in a bank or to the stipulated percentage of the gross receipts taken in by the specified station. Such a lien has been refused. Mass. Gasoline & Oil Co. v. Go-Gas Co., 259 Mass. 585, 156 N. E. 871 (1927), 267 Mass. 122, 166 N. E. 563 (1929), cert. denied 280 U. S. 604 (1929); Stephenson v. Go-Gas Co., 268 N. Y. 372, 197 N. E. 317 (1935).

Holders of certain "royalty interests," similar to participating operation certificates, have also been relegated to the non-creditor class. Bank of America National Trust Ass'n v. Fisher, 61 F. (2d) 53 (C. C. A. 9th, 1932); In re Lathrap, 61 F. (2d) 37 (C. C. A. 9th, 1932), noted in (1933) 33 COL. L. REV. 355; (1933) 42 YALE L. J. 782; see Comment (1933) 6 So. CAL. L. REV. 324.

8. See notes 6 and 7, *supra.*

9. The problem of resolving the status of such security holders will doubtless continue to arise in other less frequently recurring situations, such as

(1) Taxation controversies. See e.g., Arthur R. Jones Syndicate v. Commissioner of Internal Revenue, 23 F. (2) 833 (C. C. A. 7th, 1927); Elko Lamoille Power Co. v. Commissioner of Internal Revenue, 50 F. (2d) 595 (C. C. A. 9th, 1931); Finance & Investment Corp. v. Burnet, 57 F. (2d) 444 (App. D. C. 1932); Hilson Co. v. State Board of Assessors, 82 N. J. L. 2, 80 Atl. 929 (1911); Miller v. Ratterman, 47 Ohio St. 141, 24 N. E. 496 (1890).

(2) Equity receiverships, where the problem, however, may not often arise in the future because of the Corporate Reorganizations Act. See e.g., Storrow v. Texas Consolidat-

are creditors or stockholders, in order to determine whether they may file a petition or in what capacity they may vote on any proposed reorganization.[10]

One method used by some courts in determining the status of a hybrid holder is to analyze the stock and bond characteristics of the particular security and upon that basis to fit the holder into the creditor or non-creditor class.[11] Thus, while redeemable "stocks" possess earmarks of bonds in having no voice in the management and in having a provision for the absolute payment of a definite principal sum at a fixed time, the fact that the "interest" or "dividend" payments are dependent upon net earnings or surplus, which is a usual stock feature, has been given as a reason for placing these securities in the category of

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ed Compress & Mfg. Ass'n, 87 Fed. 612 (C. C. A. 5th, 1898), cert. denied 174 U. S. 800 (1899); Bank of North America v. Pennsylvania Oil Refining Co., 216 Fed. 377 (E. D. Penn. 1914); Hazel Atlas Glass Co. v. Van Dyk & Reeves, 8 F. (2d) 716 (C. C. A. 2d, 1925); Vanden Bosch v. Michigan Trust Co., 35 F. (2d) 643 (C. C. A. 6th, 1929); Olmstead v. Vance & Jones Co., 196 Ill. 236, 63 N. E. 634 (1902); see Note (1933) 42 YALE L. J. 1128.

(3) Cases where the issuing corporation is not in liquidation, but lacks either surplus or net profits. See e.g., Acker v. Girard Trust Co., 42 F. (2d) 37 (C. C. A. 3d, 1930); Booth v. Union Fibre Co., 142 Minn. 127, 171 N. W. 307 (1919); Topken, Loring & Schwartz, Inc. v. Schwartz, 249 N. Y. 206, 163 N. E. 735 (1928); Cross v. Beguelin, 252 N. Y. 262, 169 N. E. 378 (1929).

10. Only creditors may petition for reorganization. 48 STAT. 912, § 77B (a), 11 U. S. C. A. § 207 (a) (1934). The term "creditors" applies only to those who have "claims," which in turn is defined to exclude "stock." 48 STAT. 912, § 77B (b) (10), 11 U. S. C. A. § 207 (b) (10) (1934).

The actual bargaining position of a group of security holders may be largely dependent on whether they are classified as creditors or stockholders. Whereas a plan is binding on all creditors in a particular class if accepted by two thirds of that class, the approval of a majority is sufficient to bind a class of stockholders. Stockholders are automatically bound by a plan if the debtor is insolvent. 48 STAT. 912, § 77B (b) (4), (5), 11 U. S. C. A. § 207 (b) (4), (5) (1934). See Foster, *Conflicting Ideals for Reorganization* (1935) 44 YALE L. J. 923, at 935.

Cases have already arisen on the question of whether stockholders, or others similarly situated, may be petitioning creditors within the terms of the act. Most courts have strictly construed the statute and denied such petitions. Bryan v. Welch, 74 F. (2d) 964 (C. C. A. 10th, 1935); In re Piccadilly Realty Co., 78 F. (2d) 257 (C. C. A. 7th, 1935); In re Draco Realty Corp., 11 F. Supp. 405 (S. D. N. Y. 1935); In re Arcadia Furniture Co., 12 F. Supp. 477 (W. D. Mich. 1935). *Contra:* In re Lehrenkrauss Corp., 10 F. Supp. 14 (E. D. N. Y. 1935), noted in (1935) 34 MICH. L. REV. 114. Courts may be expected to follow the bankruptcy rule that the liabilities of a corporation to its stockholders on account of their stock are not corporate debts within the meaning of the act. See Curtis v. Dade County Security Co., 30 F. (2d) 325, 326 (C. C. A. 5th, 1929).

Possibly the problem of determining hybrid holders' status may also arise in proceedings under Section 77 of the Bankruptcy Act. It appears that stockholders of a railroad may not be petitioning creditors within the terms of the act. 47 STAT. 1474 (a) (b), 11 U. S. C. A. § 205 (a) (b) (1933). But while a plan must ordinarily be accepted by two thirds of any class of creditors or stockholders, acceptance by the latter is not a requisite to confirmation of a plan if the corporation is found insolvent. 47 STAT. 1474 (e), 11 U. S. C. A. § 205 (e) (1933).

11. See Hazel Atlas Glass Co. v. Van Dyk & Reeves, 8 F. (2d) 716, 720 (C. C. A. 2d, 1925).

stocks.[12] Participating operation certificates have bond features in that no voice in the management is given, and there is an agreement to pay a definite sum irrespective of net profits or surplus, but they resemble stocks in that the time of payment is uncertain. The latter characteristic, plus the absence of an absolute promise to pay a principal sum at a definite time, have constituted reasons given by some courts for classifying the holders of such securities in a position inferior to that of general creditors.[13] The result attained by the courts in both hybrid types indicates that quantitatively the standard stock and bond characteristics are inconclusive in determining a security's status, for in both types the bond characteristics are the more numerous.[14] The question then remains whether the presence of any particular characteristic alone would be determinative of the classification of a given hybrid security.

But an analysis of the standard characteristics reveals that prediction as to a hybrid's status cannot be made on this basis. Some courts have held that where the return on the investment has been made dependent upon the existence of net profits or surplus, this factor is highly important in serving to render the security holders inferior to general creditors.[15] Yet the inconclusiveness of

12. See In re Hicks-Fuller Co., 9 F. (2d) 492, 494 (C. C. A. 8th, 1925); Finance & Investment Corp. v. Burnet, 57 F. (2d) 444, 445 (App. D. C. 1932); cf. Warren v. King, 108 U. S. 389, 398, 399 (1883) (trustees certificates). But see Best v. Oklahoma Mill Co., 124 Okla. 135, 138, 253 Pac. 1005, 1007 (1926).

13. See Spencer v. Smith, 201 Fed. 647, 652 (C. C. A. 8th, 1912); In re Hawkeye Oil Co., 19 F. (2d) 151, 152 (D. Del. 1927).

14. However, some types of hybrid securities which have more stock than bond characteristics have been held stocks.

Thus, holders of "stocks" to whom some sort of lien on the corporation's property has been promised have not been permitted to enforce the lien where creditors' rights have been involved. Hamlin v. Toledo, St. L. & K. C. R. Co., 78 Fed. 664 (C. C. A. 6th, 1897); Smith v. Southern Foundry Co., 166 Ky. 208, 179 S. W. 205 (1915); Kinston Cotton Mills v. Wachovia Bank & Trust Co., 185 N. C. 7, 115 S. E. 883 (1923); Hewitt v. Linnhaven Orchard Co., 90 Ore. 1, 174 Pac. 616 (1918). For unlitigated examples, see Georgia, Southern & Florida Rr. Co.'s 5% First Preferred Stock (mortgage); Armour & Co. of Delaware's 7% Preferred (principal guaranteed in the event of liquidation). The same result might follow in negative pledge cases, where, for example, a corporation has promised its preferred stockholders not to issue any additional bonds without their consent. Cf. Miller v. Ratterman 47 Ohio St. 141, 24 N. E. 496 (1890). On the prevalence of such restrictive covenants, see DEWING, op. cit. *supra* note 1, at 61.

Likewise promises to "guarantee" "dividends" to "stockholders" have been held unenforceable where creditors' rights have been involved. See e.g., Mercantile Trust Co. v. Baltimore & O. R. Co., 82 Fed. 360 (C. C. D. Md. 1897); National Salt Co. v. Ingraham, 122 Fed. 40 (C. C. A. 2d, 1903); Coggeshall v. Georgia Land & Investment Co., 14 Ga. App. 637, 82 S. E. 156 (1914). Notwithstanding their weak legal standing, "guaranteed" stocks may in a particular instance have a strong investment position. See MEAD, CORPORATION FINANCE (6th ed. 1930) 96. In the case of railway "guaranteed" stocks, this position may be attributed to the fact that the "guaranteed" payments are treated as operating expenses. See DEWING, op. cit. *supra* note 1, at 46.

15. This may have been the decisive factor in the many cases involving the unusual type of hybrid securities issued to stockholders upon the reorganization of the Chicago Railways Company. The only bond characteristic found in these so-called "participation certificates" consisted in the absence of any control in the management, whereas stock earmarks

this particular stock characteristic as a test is perhaps shown by the fact that, despite its presence in other types of securities, their holders have nevertheless usually been held creditors. Thus, holders of trade certificates have been held creditors although, above a guaranteed minimum interest rate, they are paid dividends pro rata with stockholders.[16] Moreover, subscribers to tontine insurance have been held creditors although, in addition to the face value of their policies, they share in profits derived from other tontine policies in the same class, such sharing, however, being contingent upon the subscriber surviving the tontine period and having paid the fixed premiums.[17] And participating bondholders have generally been considered creditors although in addition to a fixed interest return they participate equally per share in any dividends paid on common stock above a specified amount.[18] Finally, income bondholders have been held creditors although "interest" is payable only if earned within any "interest"-paying period.[19] Nor may it be said that the absence of a promise to

were present in that a permanent interest in the enterprise was contemplated and net earnings were a condition to any investment return. The holders' status was held not to be that of stockholders when they sought to inspect the corporation's books in order to force dividend payments out of net earnings, and failing this, when they sought to vote for directors. Thatcher v. Chicago Rys. Co., 297 Fed. 466 (N. D. Ill. 1924), aff'd 4 F. (2d) 63 (C. C. A. 7th, 1925); Babcock v. Chicago Rys. Co., 325 Ill. 16, 155 N. E. 773 (1927). When later a receiver had been appointed, the holders were allowed to intervene in these proceedings. In re Babcock, 26 F. (2d) 153 (C. C. A. 7th, 1928). But they were refused a lien on the corporate assets to an amount equaling the undistributed net earnings. Harris Trust & Savings Bank v. Chicago Rys. Co., 56 F. (2d) 942 (C. C. A. 7th, 1932), cert. denied, 287 U. S. 614 (1932).

16. In re Spot Cash Hooper Co., 188 Fed. 861 (W. D. Tex. 1911); Butler v. Beach, 82 Conn. 417, 74 Atl. 748 (1909); Pettingill v. State Marketing Asso., 199 Wis. 200, 225 N. W. 834 (1929). But cf. C. D. Hartnett Co. v. Shirah, 116 Tex. 154, 287 S. W. 902 (1926).

17. Breard v. New York Life Ins. Co., 138 La. 774, 70 So. 799 (1916); Pierce v. Equitable Life Assurance Society, 145 Mass. 56, 12 N. E. 858 (1887); People v. Security Life Ins. & Annuity Co., 78 N. Y. 114 (1879); Uhlman v. New York Life Insurance Co., 109 N. Y. 421 (1888). The problem as to tontine insurance subscribers is not important because this type of insurance is rare today. See VANCE, INSURANCE (1930) 47.

18. The only case found involving a security resembling this unusual type of hybrid has relegated the holders to the position of stockholders. Cass v. Realty Securities Co., 148 A. D. 96, 132 N. Y. Supp. 1074 (1st Dept. 1911), aff'd 206 N. Y. 649, 99 N. E. 1105 (1912). Treatise writers have, however, assumed such hybrids to be bonds. See DEWING, op. cit. *supra* note 1, at 112; GRAHAM AND DODD, SECURITY ANALYSIS (1934) 256; RIPLEY, RAILROADS, FINANCE AND ORGANIZATION (1915) 164, 205. The latter assumption seems reasonable in view of the fact that income bonds, where the *entire* return is contingent upon there being a surplus or net profits, are usually held to create a creditor relationship. See *infra* note 19.

19. While the pledge of the net income is binding upon the corporation issuing such securities, no encumbrance is imposed upon the firm's property. Barry v. Missouri, K. & T. Ry. Co., 27 Fed. 1 (C. C. S. D. N. Y. 1886); Willoughby v. Chicago Junction Rys. & Co., 50 N. J. Eq. 656, 25 Atl. 277 (1892); Day v. Ogdensburgh and Lake Champlain Rr., 107 N. Y. 129, 13 N. E. 765 (1887); Thomas v. New York & G. L. R. Co., 139 N. Y. 163, 34 N. E. 877 (1893); Gardner v. London, Chatham & Dover Ry. Co., (1867) 2 Ch. App. 201; see DEWING, op. cit. *supra* note 1, at 110; 2 JONES, BONDS (1935) § 803; 2 MACHEN, MODERN LAW OF CORPORATIONS (1908) § 2100; MEAD, CORPORATION FINANCE (6th ed. 1930)

pay a principal sum at a fixed time invariably determines that the holders will be held subordinate to unsecured creditors in the event of liquidation.[20] For, while irredeemable bonds[21] and tontine insurance have no definite maturity date, the holders thereof have been considered creditors. It is possible that the reservation of a power of control over the management in a particular security might serve to render the holder thereof subordinate to general creditors.[22] Yet the absence of this stock feature in any type of hybrid security whose holders have been held inferior to general creditors indicates that it will seldom prove important.[23] Moreover, the presence of this stock characteristic may be far from conclusive. Holders of voting bonds have sometimes been considered corporate creditors,[24] and holders of convertible bonds and bonds with stock purchase warrants or subscription rights have been held creditors although they may by the exercise of their option secure a permanent interest and voting rights in the corporation.[25] Nor will any particular grouping of these stock

57, 58. Where both principal and "interest" have been made payable solely out of net profits, the security has been held a stock or similar thereto. Synnott v. Tombstone Consol. Mines Co., 208 Fed. 251 (C. C. A. 9th, 1913); In re Fechheimer Fishel, 212 Fed. 357 (C. C. A. 2d, 1914); Matter of Collier, 112 Misc. 70, 182 N. Y. Supp. 93 (Surr. Ct. 1920).

The numerous reorganizations since 1930 have produced great numbers of these income bonds. See GRAHAM AND DODD, SECURITY ANALYSIS (1934) 286. For examples, see (1932) 134 COMM. & FIN. CHRON. 1039, 3463.

20. The absence of such a promise has often been held to indicate that a non-creditor relationship was intended. See Mercantile Trust Co. v. Baltimore & O. R. Co., 82 Fed. 360, 367 (C. C. D. Md. 1897).

21. Schachne v. Corporation of Chamber of Commerce, 102 Misc. 197, 168 N. Y. Supp. 791 (N. Y. City Ct. 1918); Union Canal Co. v. Antillo, 4 Watts & S. 553 (Pa. Sup. Ct. 1842); Philadelphia and Reading Rr. Co. v. Stichter, 11 Weekly Notes Cas. 325 (Pa. Sup. Ct. 1882); see DEWING, op. cit. *supra* note 1, at 76; 2 JONES, BONDS (1935) § 623; cf. Koster v. Lafayette Trust Co., 207 N. Y. 336, 100 N. E. 1117 (1913); Weinman v. Blake & Knowles Pump Works, 156 A. D. 168, 140 N. Y. Supp. 1085 (1st Dep't 1913), aff'd 214 N. Y. 702, 108 N. E. 1110 (1915). *Contra:* Taylor v. Philadelphia & Reading Rr. Co., 7 Fed. 386 (C. C. E. D. Penn. 1881); see Note (1928) 76 U. OF PA. L. REV. 80, at 84.

22. The absence of such a right has frequently been considered a determinative factor. See, e.g., Pettingill v. State Marketing Assoc., 199 Wis. 200, 209, 225 N. W. 834, 837 (1929).

23. Sometimes a lack of voting power has been held to point to a stockholder relationship. See Miller v. Ratterman, 47 Ohio St. 141, 157, 24 N. E. 496, 500 (1890). But the same provision has also been held to point to a creditor relationship. See Best v. Oklahoma Mill Co., 124 Okla. 135, 138, 253 Pac. 1005, 1008 (1927).

24. Cf. Phillips v. Eastern Rr. Co., 138 Mass. 122 (1884); New England Mutual Life Ins. Co. v. Phillips, 141 Mass. 535, 6 N. E. 534 (1886); State v. McDaniel, 22 Ohio St. 354 (1872). *Contra:* Durkee v. The People, 155 Ill. 354, 40 N. E. 626 (1895); Pollitz v. Wabash Rr. Co., 167 A. D. 669, 152 N. Y. Supp 803 (1st Dep't 1915). For an example of bondholders with a voice in the management, see the Erie Rr. Co.'s First Consolidated Prior Lien 4s, due in 1996.

Some state statutes allow bondholders to be given voting rights. See e.g., DEL. REV. CODE (1915) § 1943; N. Y. STOCK CORP. LAW (1923) § 97; OHIO GEN. CODE (Page Supp. 1934) § 8623-77.

25. If the holder of the older type of convertible bond wished to become a stockholder, he had to surrender his bond. But the more modern type with warrants or subscription rights permits the holder to purchase stock (usually common) without requiring him to

and bond characteristics prove a guide to a security holder's status. For redeemable "stocks" embody the same characteristics as income bonds, while participating operation certificates bear most of the earmarks of trade certificates[26] and tontine insurance.[27]

Thus it seems that an analysis of a particular security in the light of its stock and bond characteristics may be of little utility in arriving at its holder's status. In view of this fact it has been urged that the "general equities" of the situation should govern,[28] and holders of hybrids which contain the promise of "abnormal profits" should be excluded from the category of creditors. On this basis some holders of participating operation certificates have been held not to be creditors.[29] But the difficulty of balancing the "equities" in any situation is a convincing argument against their use as a test. Not only would it be difficult for a court to determine what constitutes an "abnormal profit,"[30] but of more

surrender his bond. See DEWING, op. cit. *supra* note 1, at 113, 114, 121; 2 JONES, BONDS (1935) § 795; MEAD, CORPORATION FINANCE (6th ed. 1930) 60; Berle, *Convertible Bonds and Stock Purchase Warrants* (1926) 36 YALE L. J. 649, at 657. It is said that the number of such speculative senior securities is destined to increase. See GRAHAM AND DODD, SECURITY ANALYSIS (1934) 176, 286; MEAD, CORPORATION FINANCE (6th ed. 1930) 422, 424, 431.

26. Another similarity between participating operation certificates and trade certificates lies in the fact that both are intended to enlist the patronage of the holder and his friends in the retail business of the issuing corporation.

27. Likewise, preferred stocks which guarantee "interest" (*supra* note 14) bear the same characteristics as irredeemable bonds.

28. See Note (1928) 28 COL. L. REV. 65, at 71.

29. See United States & Mexican Oil Co. v. Keystone Auto Gas & Oil Service Co., 19 F. (2d) 624, 626 (W. D. Penn. 1924); cf. In re Lathrop, 61 F. (2d) 37 (C. C. A. 9th, 1932). Courts usually look with disfavor upon such apparently speculative securities. See Bank of America National Trust & Savings Ass'n v. Fisher, 61 F. (2d) 53, 55 (C. C. A. 9th, 1932); Berl, *The Vanishing Distinction Between Creditors and Stockholders* (1928) 76 U. OF PA. L. REV. 814, at 821; Note (1933) 42 YALE L. J. 782, at 785.

The dangers inherent in relying on "profits" as a criterion are well illustrated by the fate of participating operation certificates. While it is apparent that the return on this investment is directly related to the number of such certificate holders and the amount of gross receipts at the specified gasoline station, courts have been quick to conclude that an investment return of 100 per cent was contemplated. There has therefore been no judicial consideration of what the actual return might be on such investments. However, it has been speculated that such a long time for repayment was contemplated that possibly no more than the ordinary interest rate was intended. See Note (1928) 76 U. OF PA. L. REV. 80, at 84.

It has been argued that such certificate holders could be held creditors by analogizing their position to that of salesmen working on commission to obtain first a return on their deposit and then a sum above this as strictly a payment for their influence in persuading friends to patronize the filling station. See Hansen, *Hybrid Securities* (1935) 10 (Unpublished thesis in Yale Law School Library).

30. The problem of determining what is a "normal" profit for a creditor has been even further complicated by the profit-sharing devices inherent in many of the modern bonds. Thus, in the bull market of 1929 speculators are said to have made "enormous" profits by purchasing bonds bearing stock purchase warrants. See DEWING, op. cit. *supra* note 1, at 122. Furthermore, the differential in yield between even high grade bonds and preferred

importance, such a test would make it virtually impossible for a prospective investor to ascertain his status in the corporation. And if the marketing of hybrid securities is to be permitted,[31] it seems desirable that the latter be fully apprised of his exact relation to the corporation.

It has been suggested that, in addition to applying the standard characteristics, other tests might be utilized in determining the relationship which the corporation and the hybrid security holder intended to establish.[32] Thus it is said to be pertinent to inquire into such factors as whether a trust deed or mortgage had been given as security; whether the issue had been authorized by the corporate charter; whether the rate of return provided for had been greater than the interest rate on a loan of similar risk; and finally whether the corporation's capital had been principally realized through the issue.[33] But admitting that the intention of the corporation and holder should govern in fixing the latter's status, it is unlikely that in many cases these factors would prove particularly helpful in pointing to that intention.

While the presence of a trust deed or mortgage as security for a particular hybrid may be said to indicate that the parties intended a creditor relationship, practically all hybrids lack any such security.[34] Similarly, in a case where the issue would be held ultra vires and void because not authorized by the corporate charter, if it were classified as a stock,[35] the presumption seems proper that the parties intended the issue to be a valid corporate debt.[36] But again, such circumstances seldom surround the flotation of any issues of hybrids.[37] The third

stocks has steadily diminished. See BADGER, INVESTMENT PRINCIPLES AND PRACTICES (1928) 210.

31. The argument has been made that redeemable "stock" issues should be prohibited or strictly regulated in order to protect investors. See Koeppler v. Crocker Chair Co., 200 Wis. 476, 483, 484, 228 N. W. 130, 132, 133 (1930); Jones, *Redeemable Corporate Securities* (1931) 5 So. CAL. L. REV. 83, at 104.

32. If on the basis of the standard characteristics the instrument is construed as having been intended to establish a stockholder relationship, any evidence showing a different intention will be required to be very clear in order to refute the terms of the instrument itself. See In re Hicks-Fuller Co., 9 F. (2d) 492, 494 (C. C. A. 8th, 1925).

33. See Note (1928) 28 COL. L. REV. 65, at 67. Relative to the factor of whether the corporation's capital had been principally realized through the issue, it would be necessary to inquire into whether the security had been issued at the time of organization, or after a substantial class of stockholders already existed. See In re Spot Cash Hooper Co., 188 Fed. 861, 863 (W. D. Tex. 1911).

34. Where "stockholders" have been promised some sort of lien, the provision has been held inoperative as against creditors. See note 14, *supra*.

35. But stockholders in a bankrupt corporation have been held estopped to plead that because they held stock which had been issued them in excess of that authorized by the charter of incorporation, they should therefore be treated as creditors. In re R. Rombach & Co., 3 F. (2d) 46 (W. D. Penn. 1924), aff'd, 9 F. (2d) 359 (C. C. A. 3d, 1925).

36. See In re Spot Cash Hooper Co., 188 Fed. 861, 863 (W. D. Tex. 1911); Allen v. Northwestern Mfg. Co., 189 Iowa 731, 738, 179 N. W. 130, 132 (1920). In one such case, however, liability has been imposed on the security holders on the basis that, even though not stockholders, they were partners, or members of a joint-stock association. C. D. Hartnett Co. v. Shirah, 116 Tex. 154, 287 S. W. 902 (1926).

37. Occasionally a loan has been purposely disguised as a purchase of redeemable

proposed factor would be of no aid in the case of those hybrids which provide that the investment return shall be contingent upon the existence of net profits, because there would then be lacking a provision for a definite rate of return. Where, however, a definite rate of return is provided, and it is shown to be greater than the interest rate on a loan of similar risk, it may be proper to hold that the parties intended a non-creditor relationship. But difficulty would arise in many cases in determining what constituted the "normal" interest rate on a loan of similar risk.[38] Thus there would be introduced an element of uncertainty similar to that raised by the test of "general equities," and the same objections would be applicable to the former as to the latter. The final factor likewise raises the problem of uncertainty.[39] For, in the majority of cases it would be most difficult for the court to set a figure in the corporation's capitalization below which certain security holders would be transformed from creditors into some kind of stockholders. At any rate, each case would necessarily have to be decided on its own facts, thereby making it impossible for a prospective investor to know his status.

Some courts have concluded that if hybrids have been represented on the corporate balance sheet or in the articles of incorporation to prospective creditors as stocks,[40] and the holders thereof have permitted such representation to be made, it will be presumed that the corporation and the hybrid holders intended that the securities should be treated as stocks.[41] The basis of such a holding is that it would be unfair to creditors relying upon such representation to have the hybrid holders treated on a par with them in liquidation proceedings.[42] That being the case, assuming other factors to point to a creditor relationship, it would seem that, logically, the hybrid holders should in such a case be held inferior only to such creditors as relied upon the representation. In the absence of such reliance there would be no reason for preferring such

"stock" in order to avoid state usury statutes. Arthur R. Jones Syndicate v. Commissioner of Internal Revenue, 23 F. (2d) 833 (C. C. A. 7th, 1927).

38. See *supra* note 30. Even assuming that it were possible to determine what is a "normal" return on capital, an approach to such a problem would be most unrealistic if it failed to take into consideration the possibilities of appreciation in market values, which supplement and perhaps exceed the current interest rate. See BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) 282.

39. This factor has, however, been relied upon in concluding that holders of redeemable "stock" cannot be considered creditors. See Hewitt v. Linnhaven Orchard Co., 90 Ore. 1, 11, 174 Pac. 616, 619 (1918).

40. The fact that occasionally the redemption agreements have been kept secret has undoubtedly influenced some courts in holding them ineffective as against creditors. Olmstead v. Vance & Jones Co., 196 Ill. 236, 63 N. E. 634 (1902).

41. Armstrong v. Union Trust & Savings Bank, 248 Fed. 268 (C. C. A. 9th, 1918); Booth v. Union Fibre Co., 142 Minn. 127, 171 N. W. 307 (1919); Koeppler v. Crocker Chair Co., 200 Wis. 476, 228 N. W. 130 (1929).

42. Public policy is sometimes said to preclude stockholders from occupying a position on a par with creditors. United States & Mexican Oil Co. v. Keystone Auto Gas & Oil Service Co., 19 F. (2d) 624 (W. D. Penn. 1924); Bank of America National Trust & Savings Ass'n v. Fisher, 61 F. (2d) 53 (C. C. A. 9th, 1932); Hoover Steel Ball Co. v. Schaefer Ball Bearings Co., 90 N. J. Eq. 164, 106 Atl. 471 (1919); Hewitt v. Linnhaven Orchard Co., 90 Ore. 1, 174 Pac. 616 (1918).

creditors over the hybrid holders.[43] A further problem is presented where an unscrupulous management, without the knowledge, and contrary to the understanding of the parties, alters the corporate balance sheet so as to represent the securities as stocks. Under such circumstances it would be difficult to spell out an intention on the part of the hybrid holders to assume a relation to the corporation analogous to that of stockholders solely on the basis of the representation made to creditors. In that case it would seem advisable to treat the hybrid holders on a par with other creditors and enable those of the latter who had relied upon the misrepresentation to maintain personal actions against those responsible for the misrepresentation.

It may be seen that all these various tests will not in many cases be of great value in establishing the status of hybrid holders where a determination thereof is essential. Moreover, no final solution of the problem appears likely at the present time. Some aid in solving the problem might be afforded, however, through state Blue Sky Laws, the Securities Act of 1933, and the Securities Exchange Act of 1934. Thus, where the combination of stock and bond provisions is such as possibly to mislead prospective hybrid holders as to their status in the event of any corporate liquidation proceeding, the Securities and Exchange Commission has power to insist that the registration statement contain a clear indication of the exact relationship which the issuing corporation intends to establish.[44] The majority of hybrids would be within the jurisdiction of the commission,[45] and for those beyond its authority essentially similar statements

43. Cf. Durand v. Brown, 236 Fed. 609 (C. C. A. 6th, 1916).

44. Hybrids are included within the term security, which "means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a security or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." 48 STAT. 905, 15 U. S. C. A. § 77b (1934).

Such information could undoubtedly be demanded in the registration statements. The statute would seem to require it in the provision for disclosure of "the amount of the funded debt outstanding and to be created by the security to be offered, with a brief description of the date, maturity, and character of such debt, rate of interest, character of amortization provisions, and the security, if any, therefor." 48 STAT. 88, 15 U. S. C. A. §77aa (12) (1934). The Commission could certainly require such information "as being necessary or appropriate in the public interest or for the protection of investors." 48 STAT. 78, 15 U. S. C. A. § 77g (1933).

45. Among the exempted securities are those which are "a part of an issue sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within such State or Territory." 48 STAT. 906, 15 U. S. C. A. § 77c (11) 1934). Thus, the Commission's jurisdiction would extend to a hybrid security such as the Go-Gas Co.'s participating operation certificates. For, the issuing corporation was organized under the laws of the State of Delaware, but marketed securities in numerous other states, *supra* note 7.

Hybrids issued in a merger or consolidation will not be exempted from the provisions

could be demanded under many state Blue Sky Laws.[46] Thereafter, the status indicated therein could be considered as a highly important factor in resolving the intent of the corporation and the holder, and thereby the latter's status. In those cases where the statement reveals that a creditor status was contemplated, and the relationship was represented as such on corporate balance sheets subsequently issued to creditors, there is no reason to relegate the hybrid holders to a position inferior to such creditors. In other cases, where, despite the indication of a creditor relationship in the registration statement, the security had subsequently been set up on the balance sheets as a stock, it might be argued that since the hybrid holders allowed the management to make this representation, they should be held to such a status as against creditors. But there would seem to be no reason for giving these creditors any such preference unless they had relied upon the balance sheet. Furthermore, even as to those who could show such reliance, little justification appears for holding them superior to the hybrid class. The creditor status revealed in the registration statement contradicts any assumption that the hybrid holders by contract agreed to be represented on the balance sheets as stockholders. And the theory that the hybrid holders acquiesced in such representation seems hardly realistic in view of the fact that investors in modern corporations can exercise no effective control to prevent the management from misrepresenting their status to prospective creditors.[47] However, creditors who had to their disadvantage relied upon the balance sheets should be given rights of action against the corporate management for misrepresentation of the hybrids' status.

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of the Act. See Hanna and Turlington, *The Securities Act of 1933* (1934) 28 ILL. L. REV. 482, at 495.

As to the Commission's jurisdiction over securities issued in corporate reorganization proceedings, see generally Comment (1934) 34 COL. L. REV. 1348; (1935) 2 CORP. REORG. 163.

46. For examples of such statutes, see CONN. GEN. STAT. (1930) § 4044; MASS. ANN. LAWS (Lawyer's Co-op., 1933) c. 110 A, § 6; OHIO GEN. CODE (Page, 1931) § 6373-9.

Some hybrid securities have been banned, and others have been held void under state Blue-Sky Laws. Cecil B. De Mille Productions v. Woolery, 61 F. (2d) 45 (C. C. A. 9th, 1932); Brownie Oil Co. of Wis. v. Railroad Commission of Wis., 207 Wis. 88, 240 N. W. 827 (1932), noted in (1932) 30 MICH. L. REV. 1113.

47. Cf. BERLE AND MEANS, op. cit. *supra* note 38, at 277-281.